The New York Certified Public Accountant

VOL. XVII *October · 1947* NO. 10

Society and Editorial Offices: 15 East 41st Street, New York 17, N. Y.

. . . and that's why you find Remington Rand's Printing Calculator producing the figure facts for so many efficient accountants.

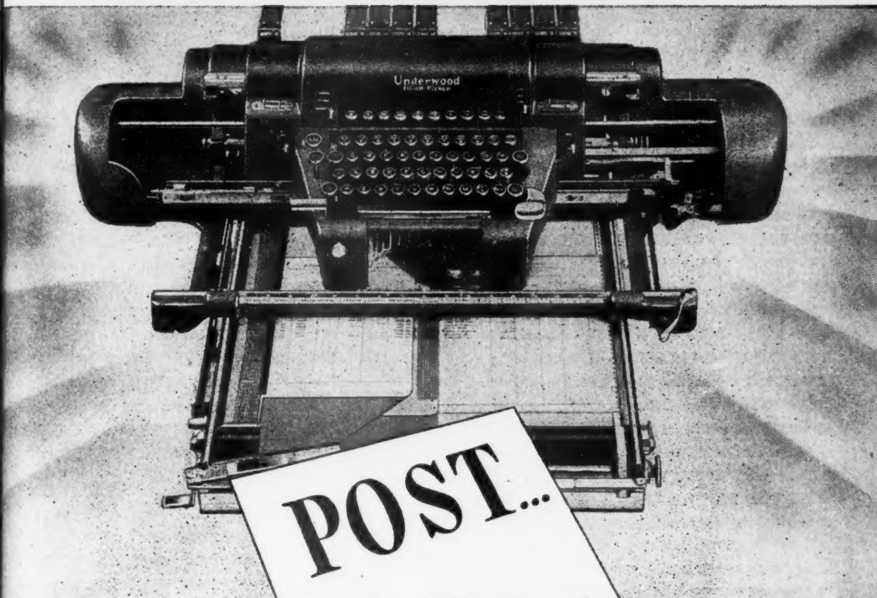
Only the Printing Calculator does *all* your figure work with printed proof of accuracy. It multiplies and divides automatically, adds and subtracts—*and* simultaneously prints the factors and answer of each calculation.

For more information, write to Adding-Bookkeeping-Calculating Machines Division, Dept. NY, 315 Fourth Ave., New York 10, N.Y.

Remington Rand

MACHINES FOR MANAGEMENT

PRINTED PROOF ON TAPE • ONE-HAND CONTROL • TWO MACHINES IN ONE • AUTOMATIC DIVISION • ELECTRIFIED MULTIPLICATION • DECIMALS PRINTED • THE ONLY ALL-PURPOSE CALCULATOR PROVIDING A PRINTED RECORD



POST HASTE

with the ELLIOTT FISHER ACCOUNTING MACHINE

ok to this versatile machine to deliver your accounting and cord-writing production with accuracy and despatch.

On the Flat Writing Surface, related forms, large and small, e quickly clamped in place. No rolling, wrinkling, or curl- g . . . always perfect registration . . . to save you time and fort . . . to give you neater work.

Lightning-fast electric action gives positive impressions der gentlest, finger-tip touch.

Payroll and Tax Accounting, Cost and Stock Records, Ac- unts Receivable and Payable, General and Appropriation dgers, Analyses and Inventory Control. With jobs like se, and many others, it's "Post Post haste" on the Elliott her Accounting Machine.

Call your Underwood office. Put this machine to work. Then tch your accounting and record-writing production hit a w high in speed, economy and efficiency.

Check these exclusive ELLIOTT FISHER features

- **FLAT WRITING SURFACE . . .** for quick alignment, insertion and removal of forms.
- **ROLL CARBON PAPER . . .** saves handling of carbon paper and assures clean, smudge-free copies.
- **ELECTRIC KEY ACTION . . .** designed and powered for speed; for typing and computing simultaneously.
- **ADJUSTABLE ELECTRIC STRIKING POWER . . .** to produce uniformly legible results whether only one or many copies.
- **1 TO 30 COLUMN TOTALS** and 1 or MORE CROSS-BALANCES as amounts are typed, they may be automatically added or directly subtracted in individual Column Registers and simultaneously cross-computed in one or more balances.

Underwood Corporation

counting Machines . . . Typewriters . . . Adding Machines . . . Carbon Paper . . . Ribbons and other Supplies

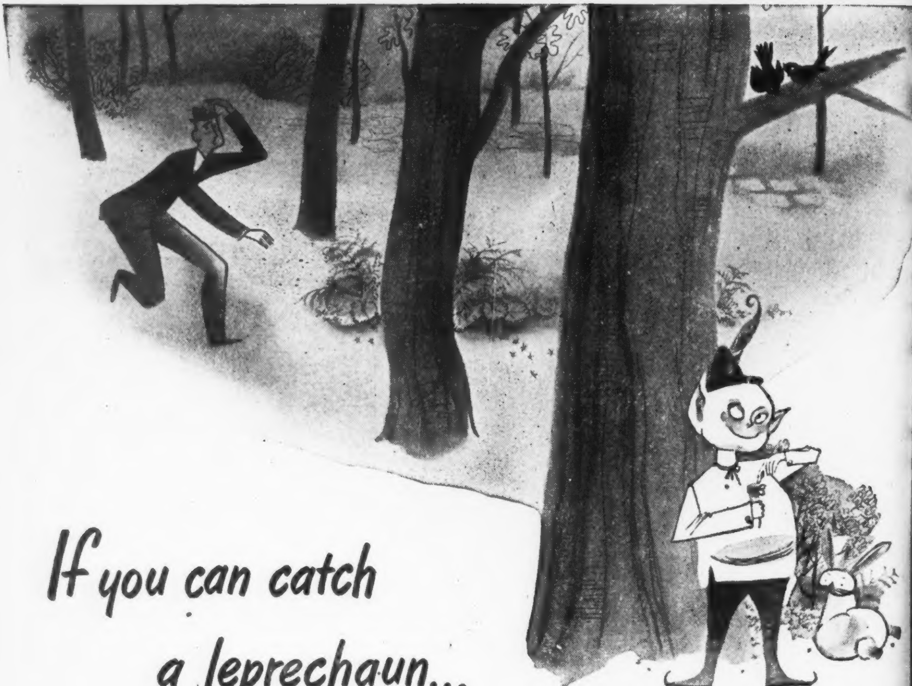
e Park Avenue New York 16, N. Y.

derwood Limited, 135 Victoria St., Toronto 1, Canada

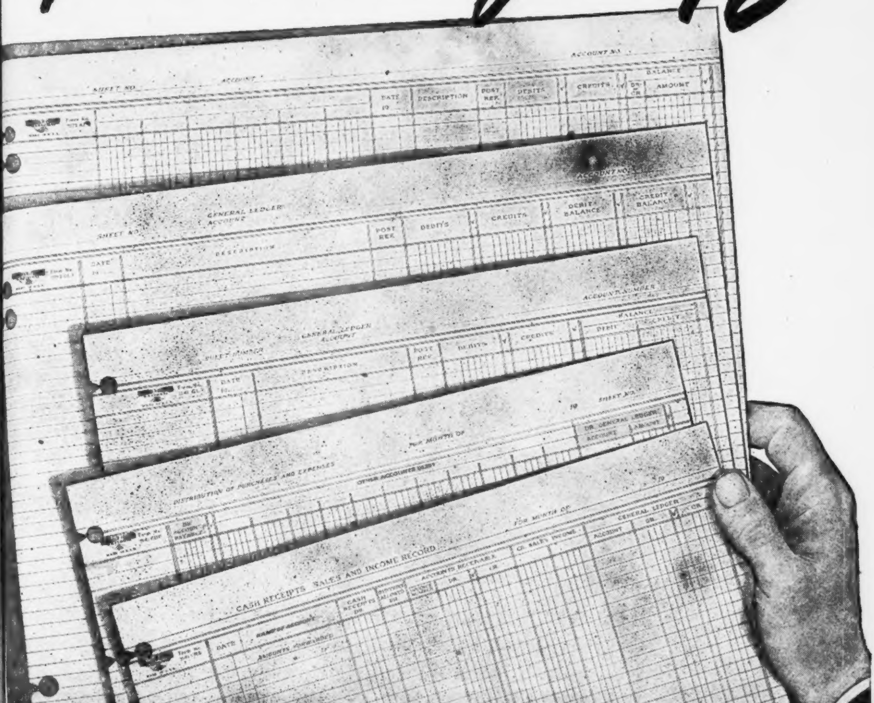
Sales and Service Everywhere

©1947

When writing to advertisers kindly mention The New York Certified Public Accountant.



Up to date... for '48



THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

VOL. XVII *October • 1947* No. 10

Vocabulary of Auditing Technique

By A. C. LITTLETON, C.P.A.

The verbs used in the literature of auditing tell what auditors do, and consequently the words acquire some measure of technical significance. An analytical study of word usage therefore could be expected to direct attention to differing types of audit action as reflected by differing shades of word meaning.

Verbs rather than other parts of speech are more important for this purpose because the verb is the kernel of a sentence predicate, and the predicate is that part which asserts something about the sentence subject. Since a subject alone is little more than the name of a category, there is not much meaning in a statement that has no predicate. In fact such a group of words would not be a statement at all.

A. C. LITTLETON, Ph.D., C.P.A., is Professor of Accounting at the University of Illinois. He is a member of the Illinois Society of Certified Public Accountants and of the American Institute of Accountants, and has held various offices in the American Accounting Association, including that of President and of Editor of the *Accounting Review*.

It is therefore not too much to say that the verb usually is the most significant part of a sentence, and that the verbs used in auditing literature directly reflect professional responsibilities and technical procedures. Rudolf Flesch (*The Art of Plain Talk*) makes this comment ". . . the lack of well used verbs is the main trouble with modern English writing."

A sample of auditing literature was examined that amounted to approximately 1720 pages.* About 75 verbs were used 20 times or more for a total of over 5,000 uses. About 400 other verbs were used less than 20 times for a total of 1,500 uses.

Frequency of Use. The most notable feature of the quantitative analysis is the fact that within a large vocabulary of audit verbs there is a high concentration upon a few words. Some 475 verbs are used approximately 6,500 times in this sample. About 85 per cent of the verbs (400 words used less than 20 times each) account for 23 per cent (1,500) of the uses. About 15 per cent (75 words used more than 19 times each) account for 77 per cent (5,000) of the uses. The top 14 words (being those with more than 100 uses) appear approximately 2,700 times.

* R. H. Montgomery, *Auditing Theory and Practice* (6th ed. 1940); W. H. Bell and R. S. Johns, *Auditing* (1941); D. L. Trouant, *Financial Audits* (1937); A. B. Cipriani, *Duties of the Junior Accountant* (1933); F. W. Thornton, *Duties of the Senior Accountant* (1932); Committee on Auditing Procedure, *Statements on Auditing Procedure* (No. 1 to no. 17, 1939-1942); American Institute of Accountants, *Examination of Financial Statements* (1936).

Thus 3 per cent of the words make up 40 per cent of the uses. The 5 words (1 per cent) above 200 uses cover about 1,400 uses (20 per cent). The single word with the highest frequency (532 uses) accounted for about 8 per cent of the total.

Auditing Verb	Frequency* of use
examine	532
verify	249
determine	229
ascertain	208
test	206
review	178
check	173
compare	172
investigate	142
consider	138
obtain	137
inquire	121
inspect	105
prepare	103

Changes in Usage. It is possible to get a small clue to the direction of change in verb usage. Because R. H. Montgomery's *Auditing Theory and Practice* appeared in the first edition in 1912 and in the sixth in 1940, it is possible to make a vocabulary comparison at an interval of twenty-eight years. Some of the change may of course represent individual taste in the use of words. But almost certainly many of the differences will reflect change of ideas in the profession.

Between the editions of 1912 and 1940 there was little change in the number of different verbs used—a decrease of about 10 per cent. There were some differences, however, in the list of high-ranking verbs.

Verb Preferences

Ranking	1912	1940
1	ascertain	examine
2	verify	ascertain
3	audit	compare
4	examine	review
5	test	investigate
6	certify	test

Some words were demoted. *Ascertain* moved from first to second; *test* from fifth to sixth; *verify* from second to twenty-third place; *audit* from third to twenty-sixth; *certify* from sixth to fifty-sixth. Other words were promoted, so to speak. *Examine* was advanced from fourth place to first; *compare* from thirteenth to third; *investigate* from twelfth to fifth; *review*, which was so seldom used in the 1912 edition as not to enter the count, came up to fourth place. Several other verbs that were not prominent as of 1912 received more attention later, that is, were used 20 or more times in the 1940 edition. These included *confirm, substantiate, analyze, scrutinize, disclose.*

These changes in the verbs preferred is informative. The words used less frequently in recent practice, such as *audit, verify, certify,* have been of a kind that was easily misunderstood by the public. They seem to carry a strong suggestion of conclusiveness, of incontrovertable fact, of categorical conviction. But these qualities cannot in the nature of the case attach to the accountant's exhibits or to the auditor's professional opinion. On the other hand, some words, such as *examine, compare, investigate, review,* have come into more frequent use, and not without justification, for the connotation of these verbs is much closer than the others to the real nature of auditing.

The importance of certain words to the profession suggests that they not only need definition but study for overtones, for varied uses, for relation to suitable companion words. The word *examine* is at the top of the list. There are many ways "to examine"; any one of the senses may be used upon occasion. The physician's deft fingers *felt* the arm for signs of a broken bone. The judge himself examined the witness, *listening* intently to the response which his questions produced. The engineer, examining the gun part with calipers, *saw* that the tolerance limits

* For an analysis of this table see the Accounting Exchange department of the *Accounting Review* of January, 1947.

were not exceeded. In examining a sample of tea, the expert took a sip of the brew to *taste* the flavor. The hunting dog examined the path until his inquiring nose *scented* a trail. How does the auditor "examine?"

Although English is a language with a very large vocabulary, many words have several meanings. Whenever a certain term is adopted into a professional usage it is advisable to establish its professional connotation. *Examine* is illustrative of this need. In accounting the word does not connote the use of the sense of smell, taste, or touch; auditors listen to answers to their questions and they see what is written on various documents and transcribed into accounts. But examine, as a technical term of auditing, means more than this listening and seeing. How much more, it is the task of textbook writers to make clear.

One other observation is in order here. Too much importance should not be attached to the fact that certain verbs are used in accounting literature with great frequency. Frequency of use is not necessarily a clue to the relative significance of the verbs. Qualitative factors are significant too. These are to be given consideration below.

In examining nearly 500 verbs for their technical significance, it will be helpful to classify them according to the pattern that lies within them. Since verbs are words of action it would be natural that some would relate to the use of technical ways and means, and others to the pursuit of professional ends and aims. The division between ways and aims is not equal. Most auditing actions involve the use of specific methods and procedures. These actions are not taken for their own sake; they are preparatory because they alone enable the auditor to take the later actions which directly reflect his professional duties and objectives, and the discharge of his contractual obligations.

Activity Pattern. The center of the pattern is formed by a relatively small number of auditing verbs—those which say something about duties, objectives, purposes, aims and ends. Typical of the verbs in this area are *understand, report, recommend.* Most of the verbs must be arranged about this center; those outside are the ones which say something about techniques, methods, procedures, ways and means. Typical of these are *examine, inquire, allocate, authenticate.*

As we work with the words relative to duties, it becomes clear that there are several classes of duties; certain verbs are particularly appropriate to certain duties.

The auditor's duty to the public (of whom the client is a part) is implicit in such verbs as *report, state, comment, disclose, certify, qualify, express an opinion.* The meaning of these terms is: to reveal the full, relevant facts with an expert's feeling for their significance as objectively determined facts and with a professional man's regard for factual dependability.

The auditor's general duty to his client as an individual is broader than that of reporting. Some of the verbs reflecting this aspect of auditing have a connotation of learning something from the client and members of his staff. These are *confer, consult, cooperate, discuss.* Others reflect a duty to teach the client and his employees: *advise, counsel, influence, instruct, educate.* This teaching function draws other verbs around it to express differences in aim and emphasis. Words like *notify, inform, suggest* are mild, while *criticize* and *condemn* are strong. Between these extremes are the more suitable words of *approve, commend, recommend, advocate, persuade, urge, convince.* This last group is particularly descriptive of the way the professional accountant prefers to influence the client. As a whole these verbs mean: to lead the client toward a better control of his affairs.

The auditor also has a duty to his profession, or perhaps better, to his professional conscience. He has a moral

duty to *detect, discover, uncover* such things as fraud, error, misrepresentation, distortion, ignorance. A great many of his techniques are focused here. He has an intellectual duty to *understand, judge, decide*. But to discharge the duty of understanding he must first *recognize, select, exercise care, distinguish, discriminate, interpret*. And to discharge the duty of judging he must first *verify, substantiate, corroborate, establish;* in other words, *satisfy himself*.

In moving to influence the client, the auditor follows the road of persuasion. But when his moral or intellectual duty is involved, stronger verbs come into play. In the processes of uncovering and of judging he may find it necessary to *refuse, restrict, decline, refrain, limit;* and he may have to *demand, insist, ignore, object, disagree*. These are strong words; most of them express a clear dissent. The public accountant therefore is not all fair words and persuasion; when he has to put his foot down, you may hear the floor boards creak. But not from stamping and ranting. If there is any creaking it is from steady pressure calmly maintained. These verbs are associated with his duties to the profession, and they mean, as a group: to understand what is, in the light of what ought to be.

In this attempt to see a pattern in the verbs of auditing, a central area of 55 words is found in which certain groups of verbs express various auditing aims and duties. Three groups as specifically identified above are:

(1) Verbs which mean to reveal the full relevant facts with an expert's feeling for their significance as facts and a professional man's regard for factual dependability. (7 verbs)

(2) Verbs which mean to lead the client toward a better control of his affairs. (21 verbs)

(3) Verbs which mean to understand what is, in the light of what ought to be. (27 verbs)

Probably this showing is in general accord with the opinion of most informed observers. It surely is the central purpose of auditors to understand, to reveal, and to lead. And it is to be expected that the verbs which express technical actions will be found, upon classification, to suggest the varied ways and means by which the auditor gains his understanding and does his revealing and leading.

Before the auditor can discharge with assurance the numerous responsibilities suggested above, he will need to employ many special techniques of investigation in order to gain full and clear insight into the client's accounting methods and results. Some of the corresponding verbs of ways and means have a rather general connotation; others present various aspects of specific techniques.

Verbs of Ways and Means. In the first class are a number of verbs carrying the general sense of *find out*. Here are *ascertain, explore, investigate, determine, acquaint self, familiarize self, seek, search, trace, study*. These terms imply that the auditor finds out by doing something himself. Others indicate that he finds out through a technique of making contacts with people. Here are *ask, inquire, interrogate, question, interview, request, require, solicit, elicit*. A few more have a similar general meaning but are not readily classified in either of these two groups: *secure, procure, obtain, gain access, account for*.

There are other techniques of ascertaining besides that of "asking;" there are also those which center about "see." Here are grouped directive verbs such as *see, observe, notice, watch, read, consider, scrutinize, examine*. With slightly different connotation are certain limiting verbs, such as *review, sample, survey, scan,* which suggest restricting the volume of detailed "looking." But there is more to an auditor's looking than merely seeing; he learns much that is significant by contrasting this with that. Hence the following verbs expressive of contrasting are also

important in his work: *check, re-check, compare, audit.*

A good deal of auditing action is inspired by the question: Is the showing authentic? It is entirely natural therefore that a number of technical verbs should suggest such actions. The verb *authenticate* typefies the group generally; with it should go *identify, support, vouch.* Some of the others, such as *confirm, circularize, communicate, correspond,* mean getting facts by writing rather than by speaking. Others indicate actions somewhat related to arithmetic: *count, foot, figure, estimate, compute, calculate, average, approximate.* The list of verbs related to authenticate would not be complete without certain other terms of important technical significance in auditing methods. These are *analyze, reconcile, agree, correlate, prove, test.*

The above grouping of technical verbs is of course leading up to those involved in "reporting." But some others are to be noted first which are closely related, but preliminary to, reporting itself.

One group of verbs connect the auditor's work rather directly with the accounting necessity for sharply distinguishing data affecting different fiscal periods. Here are included *adjust, change, correct, reclassify, add, deduct, eliminate;* and the more characteristic words relative to periodicity, such as, *accrue, defer, accumulate, amortize, apportion, allocate, capitalize.*

Another group of words immediately proceeding those dealing with reporting express the general idea of organizing the materials for use in preparing a report. These verbs are *list, copy, record, compile, tabulate, schedule, separate, segregate, consolidate, classify, marshall.*

Finally the verbs that apply to the report: The auditor will *write, draft, prepare, sign* the report; then he will *issue, supply, render* and *submit* the report. Within the report he will *embody, incorporate, present, provide, reveal, display, exhibit,* appropriate details and summaries. In the text, he will *explain, amplify, elaborate, describe, refer to, point out, mention, justify, emphasize, summarize, outline, footnote.*

This qualitative analysis has presented 170 verbs (out of nearly 500 words tabulated) as being the ones that have the most meaning in auditing. Nearly one-third (55) lie in the center of the pattern and relate to professional aims and duties. The remaining 115 words are related to various techniques dealing with the ways and means by which the public accountant does the technical work that enables him to discharge his duties as auditor.

Relative Significance. For some purpose the most significant verbs of auditing are those relative to the auditor's duty to the public (*disclose, express, opinion*), duty to the client (*consult, advise*), duty to the profession (*judge, satisfy self*). Verbs like these explain the profession and activate the professional. But for the man in the field and for the student in school the most significant verbs refer to professional techniques, the ways of doing what needs to be done. Thus to *find out* one must *ask, observe, review, compare, study; to authenticate* one must *vouch, confirm, compute, reconcile;* to *report* one must *reveal, explain, qualify.*

If we boil down the kettle of verbs still further perhaps the sample might come down to this as an expression of the essence of auditing.

> *Ascertain* by *examining* in order to *report.*

This sentence, like most broad generalizations, is so compact that it needs some expansion to be meaningful. Ascertain what? The facts. Examine what? The evidence. Report what? An opinion. Thus broadened the three essentials became:

> *Ascertain* the relevant facts and the accounting treatment given them in the enterprise.
>
> *Examine* and evaluate the evidence sup-

porting both the originating transactions and the subsequent periodic treatment.

Report a considered professional opinion of the disclosures prepared for interested parties.

If it be desired to bring the vocabulary to the sharp point of a single verb of highest significance, this could very well be *satisfy self*. The auditor if under a heavy obligation to satisfy himself as to the accounting truth of what he examines; there is little point in merely going through the motions of using technical procedures.

The auditor is concerned with factual truth. He must satisfy himself that the transactions happened as shown and that other relevant transactions are not omitted. The way to go about satisfying himself in this connection is to make intelligent use of proper professional techniques. To do this requires a satisfactory knowledge of accepted practices, both those in auditing and in business.

The auditor is also concerned with statistical truth. He must satisfy himself (1) that classification of accounting data into categories (accounts) has been according to the nature of the transaction rather than by accident or whim, and (2) that reclassification of data in making assignments to periods has been made objectively and with good judgment. The basis of satisfaction in this connection is a knowledge of the theory of accounts and of the principles of correct determination of periodic net income.

In undertaking to satisfy himself the auditor puts his knowledge of what is good up against what he finds. Hence, if he is to emerge with a true professional opinion, he must have (1) a prior knowledge of good and bad in accounting and of a wide variety of auditing procedures, and (2) a present skill in making appropriate selections from his stock of audit techniques and in applying them intelligently to the current situation.

Auditing is research; it is more than checking. For the emphasis is on thinking. Most auditing texts undertake to tell the student what to do; but they could very well tell more of what to think while doing. "Watch the bacon, dear, while I run out in the garden a few minutes," a mother said to the six-year old daughter. The bacon was dutifully, though tearfully, watched; but it burned to a crisp. Watching had not been enough. In auditing it is more important for the junior assistant to think what he is looking for than it is that he quickly compare recent sales invoices with the figures in the sales book. He too has to *satisfy himself;* and he must have some questions in mind to satisfy.

Sampling Theory Applied to the Test-Audit

By Jerome Abrams

The Need for Standards of Sampling

It is readily admitted by many auditors that there are no established standards or rules available to guide them in the selection of the items which they test during the course of their auditing procedure. Rather have they developed their own rules of practice as to sampling methods and then continued to apply them, often without any supporting basis in any of the well-established rules of sampling. In many other fields of research (e.g., market research, quality control, engineering research) the basic rules of sampling have been established through both theoretical and empirical considerations. Much use has been made of the results of tests of specially selected samples. For if the samples tested are selected in a manner which insures, to a high degree of probability, that they are representative of all the items under consideration, including those not examined, then the researcher may draw conclusions which it is highly probable will be true about all of the items.

The auditor is a research expert in the true sense of the word. He must delve into the books of account of his client, and on the basis of his research into the transactions entered in these books, the auditor must submit an opinion as to the correctness of his client's financial statements. To certify to their absolute accuracy would necessitate a complete audit of all of the transactions of the client as well as a complete search for suppressed transactions. But limitations of time, cost, and necessity result in a test-audit.

Jerome Abrams was graduated *magna cum laude* from The City College of New York with the degrees of B.S. and M.B.A., specializing in statistics and accounting. He completed a one-year fellowship in economics, and is now engaged in the public practice of accountancy as a member of the staff of Simonoff, Pevser and Citrin, C.P.A.'s. He is a member of the American Statistical Association.

The purpose of a test-audit is substantiation by audit procedure of the correctness of the assets, liabilities (actual and contingent), reserves, capital, and surplus as at a balance sheet date, and selective audit tests of the transactions for a period ended on the balance sheet date.

It has been stated that:[1]

> "The character and extent of the tests will be governed by the circumstances of each case and should be so designed as to satisfy the auditor of the general correctness of the recorded transactions for the period, although such tests will not necessarily disclose every irregularity."

It would seem, from the foregoing quotation, that the determination of the size of the sample, the selection of the items to be tested, and the drawing of statistical inferences are inherently and irrevocably subjective. How, then, can the auditor feel secure in issuing his certificate as the result of a test-audit? His feeling of security lies in his belief that by examining a part of the records, he can obtain an impression as to the essential accuracy of the whole. But the selection of this "part" is highly important if the laws of probability as applied to auditors' samplings are to be relied upon. The method of selection of the "part" to be examined is described in the rules of sampling.

If certifications are to be based upon information derived from samples, it may, in the future, be incumbent upon the auditor to prove the reliability of his sample. The object of this paper is

Ed. Note: This paper contains a summary of the conclusions of the author, more fully set forth in the thesis written by him in partial fulfillment of the requirements for his M. B. A. degree. It is presented in the hope that it will stimulate interest in the problem as well as further study and expression of opinion.

1 "Tentative Classification of Accountancy Services," from a *Special Bulletin of the N. Y. State Society of C.P.A.'s*, January 12, 1933.

to acquaint the reader with some of the basic principles of sampling theory and their applications to auditing.

Sampling Defined

By the sampling process is meant the use of an analysis of a part from which to draw conclusions as to the whole. Or, to use the terminology which will be employed in this paper, the "whole" will be called the "universe." Thus, to reword the definition, it might be said that "a sample from a universe is a selected number of individuals each of which is a member of the universe."[2] As applied to auditing, all of the items of one type form the universe. For example, all the accounts receivable balances form the universe. But the selected few balances which will be tested form the sample. This sampling is the basis of the test-audit. Of course, the discovery of a fraudulent entry during the course of the sampling procedure might very well necessitate a complete audit.

Both intuition and experience tell the layman that a sample will reflect, in some measure, the attributes of the parent universe. Thus, a grain merchant, through long experience has learned that by obtaining from the middle of the sack a sample of the wheat he is contemplating purchasing, he can decide upon the quality of the entire sack of wheat. Experience has justified his faith in the sample. So too, the auditor will dip into the sack of transactions, although not into the middle alone, and on the basis of his analysis of the sample, will make his adjustments and decide whether or not to give his approval or certification to the recording of the entire mass of transactions of that particular type.

Test-audits of the various types of transactions (e.g., voucher register footings, cashbook postings, inventory types, accounts payable balances, and accounts receivable balances) will call for only slightly different variations upon the application of the basic rules of sampling.

There are three major considerations for any sample:[3]

(1) The sample must be *representative.*

(2) The sample must be *adequate.*

(3) The sample must show *stability.*

A *representative* sample is one which shows the same characteristics as the universe which is being sampled. Nothing can completely assure the auditor that his sample shows the same characteristics as the whole mass of data in the problem, but "according to the theory of probability, if a sample group of data has been selected at random it will be representative."[4]

Adequacy of a sample is ensured when the probabilities of any two items being in the sample are equal, and enough items are included in the sample to eliminate the possibility of distortion by being too small.

A sample shows *stability* when its results narrow in divergence to the point where an increase in the size of the sample leads to no significant change in the previous findings.

What does the auditor usually desire to find from his sampling process? First, he would like to uncover any possible fraud. Second, he would like to draw a conclusion as to the correctness of the financial statements which he is asked to certify. It should be brought to the attention of the reader that, having discovered a certain dollar amount of error in any particular group of transactions during the sampling process, it is still impossible to estimate mathematically the total dollar amount of error which may actually exist in that particular universe. However, from information derived from a sample which has satisfied the three require-

[2] G. Udny Yule and M. G. Kendall, *An Introduction to the Theory of Statistics,* (London, Chas. Griffin & Co., Ltd., 1940), p. 332.

[3] Leo Herbert, "Practical Sampling for Auditors," *The New York Certified Public Accountant,* January 1947, Vol. XVII, No. 1 (New York, 1947), p. 58.

[4] James G. Smith, *Elementary Statistics,* (New York, Henry Holt & Co., 1934), p. 325.

ments listed above, it is possible to form a well substantiated opinion as to the strength of the system of internal control and the reliance which may be placed thereon to prevent or locate any relatively large errors which may be large enough to distort the true picture of the financial condition of a business.

Determining Sample Size

The amount of test-checking depends upon an *a priori* estimate of the strength of the system of internal check. This may seem illogical, since the object of the sampling is to determine the strength of the internal control. But it is the only practical approach to the problem. If our *a priori* estimate is proven over-optimistic by the results of the first sample, it may be necessary to take an additional sample. In the opinion of the writer, there has not as yet been devised any method to determine mathematically the size of the auditor's sample.

There is one widely quoted table, purporting to give the most economic random sample, expressed as a percentage of the universe being sampled, for finding at least one false item among an assumed number of false items in a group of transactions. This table, the work of Carman and Prytherch,[5] was computed by determining the area under the normal curve and, it is said, "may reasonably be expected to be accurate when the items being tested form a normal disribution."[6] However, it is this writer's contention that practically none of the items tested by an auditor form a normal distribution. Since the usual percentage of defectives among the items sampled is very small, the type of curve formed by the sample is very much skewed—the Poisson curve is followed and not the normal curve—a vastly different matter. No attempt will be made in this article to present a new table based on the Poisson distribution, but it was felt that the inaccuracy of the Prytherch table ought to be pointed out.

Suffice it to say, at this time, that the stronger the system of internal control, the smaller need be the size of the sample. But this statement, too, which has been unquestionably accepted in the past by auditors, is subject to qualification. Suppose that hundreds of pages of inventory sheets were being test-checked for the correctness of extensions and footings. Imagine further, that we were checking inventory sheets of two clients: one whose sheets were really 1% defective (i.e., one of each one hundred items were in error) and one whose sheets were really 5% defective. Mathematical calculations, based on the theory of probability, show that with sample size 100, the probability of distinguishing between the true accuracy of the two clients' sheets is not high. As a matter of fact, the probability of rating them in reverse order is not too unlikely. Where the fraction of defective items is very small a sample will usually give an over-optimistic picture of the percentage of items containing errors, by understating the percentage. A noted statistician has concluded, on the basis of wide experience, that:[7]

> "For most purposes sample sizes of the order of 300 to 600 are a minimum for achieving satisfactory working estimates of the lot fraction defective from the evidence of a sample, and . . . very small samples are not only practically worthless for distinguishing between lots (except where defectives are overwhelming) but likely to be positively misleading."

Types of Sampling

There are three major types of sampling: (a) *random* sampling, (b) *stratified random* sampling, and (c) *purposive* sampling.

By *random* sampling is meant the selection of a sample in such a way that each item in the universe has an equal

---

[5] Robert H. Prytherch, "How Much Test Checking Is Enough," *Journal of Accountancy*, December 1942, Vol. 74, No. 6, (New York, 1942), p. 528.

[6] Herbert, *op. cit.*, p. 61.

[7] Leslie E. Simon, *An Engineers' Manual of Statistical Methods*, (New York, John Wiley & Sons, Inc., 1941), p. 25.

chance of being part of the sample. In selecting the sample, there must be no element of preference or bias that would tend toward the inclusion or exclusion of certain members of the larger group. Intelligent planning is needed in securing a purely random sample. The obvious procedure of picking the most readily available cases would by no means meet the condition of random selection.

From the above considerations of random sampling, it can be seen that there are many situations when one must depend on getting a random sample. If the auditor's knowledge of the universe, prior to sampling, is limited, and if he is unacquainted with the subgroups of the universe, the auditor can do no more than take the best random sample under the circumstances. This is usually the type of sampling to apply to inventory sheets in checking extensions of individual items or footings of individual sheets. Methods of obtaining purely random samples will be described below.

But the auditor should be certain to employ the *stratified random* sample whenever he has precise knowledge as to the internal structure of any group of items. The universe should be broken down into various sub-universes, according to dollar amounts, and the percentage of items examined in each subgroup will vary with the dollar value of the items in the group. This is the usual procedure to be followed in the verification of accounts receivable and payable balances.

A *purposive* sample is one selected by design of the auditor who seeks to secure a sample "having the same characteristics as the universe in respect to one or more 'control' factors."[8] An illustration of the purposive sample in auditing is the examination of the first and last months of a period because of the larger chance of finding fraud or mistakes in these months.

But, however complete the auditor is in his examination of these particular periods, knowledge on the part of the embezzler of the program of audit (which is often unchanged with respect to work involving the first and last months) may easily lead him to confine his peculations to other periods. Not only this, but errors of other types than fraud are just as likely to occur in any month as in the first and last months (e.g., errors of principle, clerical errors, etc.). Therefore, much more need is present for the use of a stratified random sample which will catch not only the embezzler's frauds, but errors of all types. A stratified random sample will give the auditor a much more adequate picture of the entire books of account. As has already been pointed out, the basic method of stratified random sampling lies in "dividing the parent population into strata and taking a random sample from each stratum."[9] Below are presented illustrations of the manner in which random sampling is combined with stratification.

Illustrations of a Stratified Random Sample

Accountants Receivable. In the verification of accounts receivable balances by communication with the debtors, it is always advisable to seek 100% confirmation of all accounts over a certain dollar amount in order to establish the reliability of the greatest dollar value of the receivables. The remainder of the receivables should be sampled. By sampling is meant the persistent and relentless following through of the receivable to a final conclusion. That is, the amount receivable is either verified exactly, or is reconciled with the debtor's verification, or is found to be incorrect. Once an item is selected to be part of the sample, it must be followed up until just such a decision can be made as to its accuracy.

The receivables should be broken down into sub-groups. For example, balances over \$1000.00, amounts from \$500.00 to \$999.99, from \$100.00 to

[8] Frederick C. Mills, *Statistical Methods,* (New York, Henry Holt & Co., 1938), p. 462.

[9] Yule and Kendall, *op. cit.,* p. 347.

$499.99, from $.01 to $99.99, and balanced accounts which have been active in recent months. Varying percentages should be examined from each group, in relation to the relative dollar value of the items in that group to the total dollar value of all receivables. In order to eliminate chances of gross errors, the largest group will probably be 100% verified.

It is common practice in market research to obtain a sample of a specified size, say ten percent of the universe, by selecting from a directory containing the names of all the individuals in the universe (e. g., a particular city), every tenth listing. So too, the items which the auditor wishes to sample are listed in his client's records—records which are analagous to the directory mentioned above.

> "If a given population consists of a list of objects in which the attribute of an object is independent of its position on the list, members of the population selected by some ordinal position will be a random sample for the purpose of studying the given attribute." [10]

Each item on a page will belong to only one particular stratum. One stratum will be sampled at a time. If the sample is to be of twenty percent of the items in a stratum, the auditor will skim over the pages containing the names of debtors, seeking confirmations from and examining supporting evidence for every fifth item encountered belonging to that particular stratum. This will not be every fifth item on each page, but rather every fifth item in that particular stratum. For example, suppose that a fifty percent sample of all accounts receivable balances of $500.00 to $999.99 is being taken. Then, the auditor will skim over the schedule of receivables and seek confirmations and examine supporting evidence (e. g., shipping receipts, receipt of cash payment in the month following the date as of which the audit is being made) for every second balance of $500.00 to $999.99.

The method of ordinal selection is the most economical procedure to employ in securing randomness within a stratum. However, the auditors must be sure that there is no correlation between the position of the sampled item and the characteristic for which we are testing. In most cases there will be no such correlation and the method of ordinal selection will be most appropriate.

> "If this matter is viewed from the standpoint of the axiomatic theory of probability the absence of knowledge about relationship between the method and the characteristic under consideration may be sufficient to ensure randomness . . . The presumption is that if we make as great an effort as possible to ascertain whether any relationship exists and we fail to find it, there is no relationship; and hence we can assume randomness with more or less confidence." [11]

Although it is a more costly process, the use of random sampling numbers is also available to auditors. An ordinal number is attached to each member of the population to be sampled by the simple process of numbering the members from 1 onwards. The set of ordinal numbers so obtained is the new universe and the problem of drawing a random sample reduces to finding a series of random numbers. The necessity for requiring the auditor to construct random series of his own has been obviated by the publication of various tables of random sampling numbers. There are three such available:[12]

> "(1) Tippett's numbers comprise 41,600 digits taken from census reports combined into fours to make 10,400 four-figure numbers (*Tracts for Computers*, by L. H. C. Tippett, Cambridge University Press, London, 1921, No. 15).
>
> "(2) Kendall and Babington Smith's numbers comprise 100,000 digits grouped

---

[10] James G. Smith and Acheson J. Duncan, *Sampling Statistics and Applications*, (New York, McGraw-Hill Book Co., Inc., 1945), p. 156.

[11] M. G. Kendall, *The Advanced Theory of Statistics*, (London, Chas. Griffin & Co., Ltd., 1943), pp. 191-192.

[12] Kendall, *op. cit.*, p. 193.

in twos and fours and in 100 separate thousands (*Tracts for Computers*, No. 24).

"(3) Fisher and Yate's numbers comprise 15,000 digits arranged in twos."

To draw a random sample, tables of random sampling numbers are used according to the procedure explained below. More detailed examples of their use may be found together with the tables listed above.

After the members of each stratum are assigned numbers, a sample of size N is chosen by selecting any set of N numbers from the table of random sampling numbers. Suppose that a sample of 850 from a stratum of 8500 accounts receivable with balances of $.01 to $49.99 is desired. The debtors are listed in a schedule. The first debtor is numbered 1 and the last debtor is numbered 8500.

The auditor then opens up any one of the three tables mentioned above to any page and copies down the first 850 numbers listed in the table. The debtors whose numbers correspond to the 850 selected from the table will constitute the required random sample. For example, below is presented the first 200 numbers of the Kendall-Babington Smith tables of random sampling numbers:

Random Sampling Numbers

23 15	75 48	59 01	83 72	59 93	76 24	97 08	86 95	23 03	67 44
05 54	55 50	43 10	53 74	35 08	90 61	18 37	44 10	96 22	13 43
14 87	16 03	50 32	40 43	62 23	50 05	10 03	22 11	54 38	08 34
38 97	67 49	51 94	05 17	58 53	78 80	59 01	94 32	42 87	16 95
97 31	26 17	18 99	75 53	08 70	94 25	12 58	41 54	88 21	05 13

If the auditor were to use the complete tables (of which the above is just a small segment) in the previously mentioned case, he would select the first 850 numbers. Reading across are found the numbers 2315, 7548, 5901, 8372, 5993, 7624, (9708), (8695), 2303, 6744, 0554, 5550, etc. The two numbers in the brackets are greater than 8500 and therefore are ignored. Then, confirmation requests would be sent to the debtors whose numbers correspond to the first 850 appearing in the tables, with intensive follow-ups on these particular 850 customers in an endeavor to secure as close to a 100% response as possible from these accounts receivable. In addition, careful scrutiny would be given to any and all supporting evidence for these 850 balances. Whereas a 60% response from all debtors in this stratum was formerly considered adequate, with no intensive follow-up of those not responding, it is recommended strongly that intensive follow-ups be made of those not responding in this relatively small stratified random sample. The same procedure would be followed in other strata. A 100% response from the debtors sampled should be the auditor's goal. A sixty percent response from all debtors in the $.01 to $49.99 stratum may have meant, in absolute numbers, 5100 responses. The 3400 non-responses may very well include clues to inaccuracies in the balance sheet, the profit and loss statement, and inadequacies in the system of internal control. But, blinded by the large absolute number of confirmations, the auditor disregards the 40% of non-responses. And therein lies danger.

To repeat: a small, stratified, random sample with very nearly 100% response may be of greater value to the auditor in judging the accuracy of the schedule of accounts receivable (or accounts payable) balances than a very large, non-stratified, non-random coverage for which only 60% of responses are received, though that 60% be, in absolute numbers, many times greater than the sample.

It is realized that it may be difficult to obtain so complete a response on the first request. Therefore, second and third communcations may have to be sent. However, the receipt of cash for the balance due, in the month following the date as of which the audit is made, may be used instead of a written confirmation from the debtor. Ageing of all the accounts receivable balances is, of course, an indispensable part of the audit. Accounts much past due should be confirmed whether or not they happen to have been selected as part of the original sample. For these items are often the breeding ground of fraudulent transactions.

Accounts Payable. The foregoing discussion of receivables is applicable in its entirety to payables, with the additional caution that the sampling of apparently balanced accounts be more intensive. An analysis of the records and correspondence of the client should also be made for possible disclosure of any liability not appearing on the records of the company, or any contingent liabilities.

Inventories. In its "Extensions of Auditing Procedure", the American Institute of Accountants recommended that:[13]

> "In addition to making auditing tests and checks of the inventory accounts and records, he (the auditor) shall, wherever practicable and reasonable, be present, either in person or by his representatives, at the inventory-taking and by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof. In this connection the independent certified public accountant may require physical tests of inventories to be made under his observation."

The atttendance of his staff men at the taking of an inventory should be a major consideration in any audit by a certified public accountant. In physically test-checking the inventory it is of prime importance that not only the most easily accessible objects be counted, but that a truly random survey should be made of the entire inventory. Items of approximately equal dollar value may be sampled through the ordinal method previously described. Where goods are stacked in bins, in rows, or piles, every second or third bin, for instance, may be test-checked for a second time by a staff man, or he may pay special attention to the initial inventory-taking by the client's staff at these particular locations. Better still, to obtain the element of surprise, the bins or piles corresponding to a series of random sampling numbers may be test-checked by a staff man. Of course, where individual items are of a relatively large dollar value, a complete recount may have to be taken by the staff man or his attendance may be required at the initial inventory-taking. As an additional safeguard, it is recommended that in test-checking prices of the inventory, a slightly different percentage of items be examined by ordinal position on the inventory sheets, so that not all the same items are both physically counted and priced. Here too, a series of random sampling numbers may be used in determining which items shall be test-checked for prices. This will be a two-edged sword. Randomness will be obtained both in test-checking the physical count and the pricing. After this is done, it is probably best to completely check the extensions and footings, although this, too, may be done by sampling, where the inventory sheets run into the hundreds or thousands.

Payrolls. Although payrolls are often the major components of the cost of goods sold section, the time cards which form the basis for the audit of this expense item are, in many cases, too voluminous to receive detailed checking. Then again, internal control may be so strong as to obviate the need for

---

[13] "Statements on Auditing Procedure, No. 1" issued by the Committee on Auditing Procedure, American Institute of Accountants, October 1939, p. 6.

any detailed examinations. Where this is the case, another opportunity presents itself to apply the method of stratified random sampling.

Where there are a number of departments among which the rate of compensation varies to an appreciable extent, it is best to test different percentages of the time cards in each department. Larger percentages should be sampled in the more highly skilled departments, where the wage rates are higher. The same methods of choosing time cards to be tested are employed as in the sampling of accounts receivable and payable balances. The time cards may be arranged within departments in alphabetical order and then either the ordinal or random sampling number methods may be applied, as previously described. If the cards are already numbered, there is no need to alphabetize them. For in this instance, random sampling numbers may very easily be used to draw a random sample. The cards selected will be checked for computations of hours worked, extensions of wages earned, and postings to the payroll books. A small sample will usually suffice to demonstrate the accuracy of any department's payroll. Of course, where any evidences of fraud are uncovered, a more detailed audit of the payroll is in order.

Purchase and Expense Vouchers. Resort may be had to test-checking where the volume of purchase and expense is too great for a complete audit, or where the internal control is strong enough to obviate the need for 100% checking. If any fraudulent transactions exist, the probability of finding at least one of these will be greatest through the use of a stratified random sample. The principles to be applied are those already described in connection with the test-checking of receivables. To review: the auditor will first decide on the dollar classifications into which he will divide the purchases and expenses for purposes of testing. The classifications will, of course, depend on the size and nature of the business. Then, the auditor will examine vouchers and other supporting evidence for all entries in the purchase book in the amount of, say, $1000.00 and over. He will examine lesser percentages as the dollar range of the groups tested decreases. For example, by the time purchases in the $.01 to $99.99 group are examined, only one in every twenty entries may have to be tested. Although the probability of finding a fraudulent transaction in the group of purchases over $1000.00 may not inherently be greater than the chances of finding such an item in the $.01 to $99.99 group, still, we test a larger percentage of items in the former group so that we may confirm a relatively large dollar amount of purchases at the same time that we search for any evidences of fraud. Any unrecorded purchases will usually be brought to light through confirmation of accounts payable balances, as previously discussed. The same principles applied to testing purchase vouchers may be applied to the testing of expense vouchers.

Conclusion

The haphazard methods of sampling, now so commonly used by some auditors, must be refined so that any judgments based on these samples may be statistically valid. The major part of the task of correcting test-checking procedure would be solved if auditors could be taught rules of sampling.

> "Invariably I am told my samples involve unusual transactions. The real fact I discover more frequently, however, is that the unusual transactions unearthed in my samples are the usual pattern and that the *100 per cent examination of the sample* has accomplished my objective of determining what I might expect if I audited all of the transactions."[14]

[14] Quoted by Victor Z. Brink in "Auditing Practice Forum" of the *Journal of Accountancy,* June 1947, Vol. 83, No. 6, (New York, 1947), p. 525.

Reduction of Year-End Audit Time Through Extension of Interim Audit Procedures

By Hyman D. Klein, C.P.A.

Most of us have just about emerged from a rather hectic year end. While our memories are fresh from our experiences of the past several months it might be well to reflect for a few minutes on what possibilities there are or might be for the reduction of time, pressure and tension during such periods.

We have all, in some manner or other, endeavored in our own way to minimize the amount of work to be done on year-end audits. While this paper does not purport to consider all possibilities of such time reduction, it will endeavor to elaborate on a few important possibilities by means of extension of our usual interim audit procedures.

Let us now consider the following six possibilities:

1. Confirmation of accounts receivable and accounts payable.
2. Observation of physical inventory taking.
3. Limitation of audit detail work.
4. Preparation of various analyses, schedules, etc.
5. Internal control review.
6. Instructions to client's bookkeeping staff.

Hyman D. Klein, C.P.A., has been a member of our Society since 1937, and is now serving as a member of our Committees on Monthly Audits and on Accounting Procedure. He is also a member of the American Institute of Accountants.

Mr. Klein holds the degrees of B.C.S., LL.B., and LL.M. from New York University and is also an attorney. He has been associated with the firm of Seidman and Seidman since 1933.

Confirmation of accounts receivable and accounts payable

In a good many instances it is entirely feasible and desirable to confirm accounts receivable and accounts payable on interim examinations one, two or several months prior to the year end, or it may be done piecemeal throughout the year. Moreover, the use of such confirmations carries with it the surprise element which is most frequently lost on year-end confirmations. The procedure is exactly the same as it would be on the year-end. A word of caution however, is necessary. If at the year-end the auditor is suspicious of irregularities or inaccuracies, or if the interim confirmations cast a reflection on the accuracy of the receivable and payable records, then by all means it is incumbent on the part of the auditor to confirm anew at the year-end. In the usual case, however, this is generally unnecessary.

We must also remember that outside confirmation is only supplementary to our regular audit procedures and not in substitution thereof. Hence on the year-end the auditor will still have to perform the various audit steps with reference to the receivables and payables. However, he will have saved the time he would ordinarily have had to spend on instruction, mailing and checking of verification replies, which is not inconsiderable.

Observation of physical inventory taking

Observation of the taking of physical inventory is a requisite of standard au-

dit procedure if an unqualified opinion is to be rendered. Generally this step is performed at the year-end at a cost of considerable time to both the client and the auditor. Where a perpetual inventory system is maintained it is possible to observe the taking of a portion of the inventory on each interim examination and compare it with the perpetual inventory records. Thus, throughout the year the accuracy of the records will be completely tested and the auditor will be able to determine whether he can place sufficient confidence in them without having to observe a complete count at the end of the year. In addition this procedure presents a distinct advantage to the client. It permits him to take his inventory with a minimum of confusion and loss of production. He may be able to avoid shutting down his plant as is generally necessary in a year-end inventory count.

It has frequently been suggested that where perpetual inventory records are not maintained it is possible to take physical inventory a month prior to the close of the year and then adjust the year-end figure by means of the gross profit ratio giving consideration to purchases and sales during the last month. While this procedure will in all probability give a satisfactory estimate of the inventory at the end of the year, it will result in a figure that cannot be substantiated. For this reason it is not recommended as an end of the year time saving factor.

Limitation of audit detail work

Where on interim examinations the auditor has performed the audit detail and has satisfied himself as to the adequacy of internal control and the accuracy of the records and bookkeeping personnel it should be possible for him to limit his work on detail on the year-end examination. A general review should be sufficient to satisfy him as to the accuracy of the records and transactions. Of course anything unusual would require further scrutiny. The auditor must, of course, use his own judgment as to what would satisfy him. He may find it entirely satisfactory to dispense with the vouching of purchase invoices, but might nevertheless feel it necessary and desirable to vouch sales. He might think it satisfactory to just review the cash receipts and disbursements but essential to check out the bank reconciliations. The time reduction factor requires the use of sound judgment and common sense.

Preparation of various anaylses, schedules, etc.

On interim examinations the auditor should attempt to build up the various analyses and schedules necessary for his working papers at the end of the year. As a matter of fact he should endeavor to use the client's personnel insofar as practicable, to build up this data. Proper instruction during interim examinations should permit the bookkeeping staff to compile such cumulative schedules as fixed assets, insurance, taxes, drawing accounts, etc. The auditor can check out these schedules on his interim examinations. Thus at the year-end most of this work will be completed.

Similarly, throughout the year the auditor may examine pertinent data that are generally left to the closing. He may review the minutes of stockholders' and directors' meetings, treasury department reports, unusual tax problems, etc. so that these matters will be disposed of during the year.

When the auditor is called upon to prepare the personal tax returns of the client's officers, he can utilize his interim visits to compile the data with respect to income and deductions, particularly in respect to security transactions and realty operations.

Another end of the year time saving device involves the preparation of skeleton reports and tax return schedules.

Internal control review

The auditor in the opinion of his report states that he has reviewed the

client's system of internal control. He also recognizes that the system of internal control regulates the scope of his audit. It is therefore apparent that on interim examinations it is necessary and desirable to review that phase. It is a simple matter when performing the audit detail of the various phases of operations to study the client's internal control procedures. To do this will serve as a guide to the efficiency not only of the client's system but also as to the audit. We recognize that to undertake a complete study at any one time might be time consuming, but if spread throughout the year, while in the course of interim examinations, such time will not be significant. Measured in terms of time conservation at the year-end, however, it will be a considerable saving.

Instructions to client's bookkeeping staff

In addition to the various schedules, analyses and other data that the client's staff can compile, as indicated previously, the auditor may utilize his interim examinations as a vehicle for instruction of the client's staff. He may have them compute various types of accruals and deferrals, depreciation, etc., so that on the closing engagement the client's staff may have this information all ready for the auditor. It is a much easier job to check such figures than to prepare them in the first instance. He might even instruct them to place such adjustments on the books.

The auditor is also in a position, particularly on the last interim examination preceding the end of the year, to instruct the client's staff with respect to preparation of various verification forms and letters, and with respect to the arrangement of various forms and records, such as insurance policies, vouchers, bank statements, cost and market pricing data for inventory valuations, etc., so that they are available for the auditor's use and reference in the most efficient way.

The client's staff may be instructed, by means of a chart of accounts, so to arrange the trial balance that the preparation of the report and tax returns is facilitated.

Conclusion

In conclusion it must be said that reduction of year-end audit time through the extension of interim audit procedures is dependent on the auditor's judgment, his confidence in and experience with the client's system of internal control, the client's personnel, and the cooperation of the client.

The Auditor's Responsibility for Monthly Reports

By STEPHEN CHAN, C.P.A.

THE question has been raised, whether any minimum or basic audit procedure must be observed before a Certified Public Accountant is justified in releasing financial statements on his letterhead.

I have divided this topic into two sections, first, the responsibility assumed in the course of our work, and second, suggested minimum audit procedures.

The certified public accountant usually has a responsibility both to his client and to the public. Some accountants submit monthly interim financial statements merely in pencil on worksheets, others type them on plain paper without the accounting firm's name appearing thereon. The accountant's responsibility in such cases is usually limited to the client he served. However, if the accountant's name appears either on the cover or on the stationery, there is an implied indorsement, and some responsibility to the public may be created. This subject is referred to in Robert H. Montgomery's book "Auditing Theory and Practice" (on page 601) as follows:

> "The preparation of a balance sheet from books of accounts without examination is well within the scope of an auditor's services. . . . Nevertheless, a statement issued in the cover of an accounting firm, even though without a report or opinion or any statement as to the work done, may create the impression that it has the indorsement of the auditor. . . . Unexamined statements for which the auditor takes no responsibility and preliminary statements which are subject to change, should be submitted on plain paper without the auditor's watermark or letterhead and, if bound, should be in plain covers not bearing the auditor's name."

STEPHEN CHAN, C.P.A., has been a member of the Society since 1938, and also holds a membership in the National Association of Cost Accountants and the American Institute of Accountants. He is presently serving as Vice-chairman of the Committee on Administration of Accountants' Practice and is a member of the Committees on Auditing Procedure, Publications, Monthly Audits, and Furtherance of the Objects of the Society. Mr. Chan has written a number of articles which have appeared in the *Journal of Accountancy, the Canadian Chartered Accountant*, and the *New York Certified Public Accountant*. He is a partner of the firm of Eisner & Lubin, C.P.A.'s.

Statement Qualification:

As to the qualifiaction of statements rendered on the auditor's stationery, there are two points to be observed:

(1) The statements should clearly indicate in the heading or by footnote, the absence of verification by direct correspondence and physical inventory taking.

(2) If a letter or comments are submited with such financial statements, no "opinion" or "certificate" paragraph should be included, no matter how qualified.

The issuance of monthly or annual statements to clients, based on a restricted examination, without indicating that the audit has been incomplete, is improper. It is important that every such financial statement which leaves your office be properly qualified, even though you do not sign it, since you cannot control the use of these statements after they leave your office.

A general qualification may be expressed in the form of the following footnote:

> "This balance sheet has been prepared without verification of assets or liabilities

by direct correspondence or inspection, and the inventory reflected thereon is stated at the figure submitted by the management."

Some accounting firms add the following footnote to every unverified interim financial statement they prepare:

"This statement has been prepared for the management's guidance and is subject to year-end adjustments and direct verification."

Your report may include, for purposes of comparison, prior year's unaudited figures; or you may accept certain statistical data for inclusion with the financial statements. It is suggested that in all such cases the respective financial statements or schedules be footnoted to the effect that the data is presented without audit or verification.

Legal Responsibility:

Mr. W. D. Rich in his book "Legal Responsibilities and Rights of Public Accountants" states (Pages 17 and 18):

"It is the auditor's duty to inquire into the soundness, not merely the mathematical accuracy, of the figures included in the balance sheet. . . . The auditor must reasonably test the genuineness of the representation and amount of each item on the balance sheet."

An English court decision (*London and General Bank*) rendered in 1895 stated, "A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them to ask for more."

Robert H. Montgomery, in an address delivered in 1933 (International Congress on Accounting held in London) said:

"The scope of the employment cannot be determined simply from the compensation paid, though in a doubtful case the amount of compensation would be some evidence of the character of employment. An auditor may undertake to perform for one hundred dollars, work for which the reasonable compensation is one thousand dollars. He will, nevertheless, be held to have agreed to exercise the skill of his calling in the work which he agreed to do."

Auditing Standards:

Sound auditing and accounting principles apply equally to small and large engagements although the method or extent of their application may differ. It is important, both for the small and large practitioner, to conform to the releases of The American Institute's committees on auditing and accounting procedure, and to be cognizant of the accounting releases of the Securities and Exchange Commission. Definite standards of accounting and auditing are being evolved and codified, and it will be the responsibility of each practitioner to justify any departures from these standards.

Rendering an Opinion:

Rule 5, of the by-laws (Article XVIII) of the New York State Society of Certified Public Accountants, states that : *"In expressing an opinion* on representations in financial statements which he has examined, a member shall be held guilty of an act discreditable to the profession if": (and I summarize) (a) he fails to disclose a material fact necessary to make the financial statements not misleading, (b) he fails to report any material misstatement, (c) he is grossly negligent in the conduct of his examination or in making his report thereon, (d) he fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negate the opinion expressed, or (e) he fails to direct attention to any material departure from accepted accounting principles or auditing procedure.

This Rule 5, as you have probably noted, deals with so-called "certified" or "signed" statements, accompanied by the accountant's opinion or certificate. It would, therefore, clearly be improper to use the words "we hereby certify" or "In our opinion", immediately following a recital that the receivables and payables were not confirmed by direct correspondence and the inventory was accepted as stated by the

management, since this would be a direct violation of the foregoing Rule 5d, because the exceptions negate the opinion.

Relation to Credit Grantors:

We should note that the bulk of the credit grantors and banks in the New York fur, dress, textile and allied lines, rely on a once-a-year certified report and, during the remainder of the year, grant credit based on monthly or interim statements. Even if only in telephone conversation, your interim reports are thus circulated among the clients' creditors.

In order to avoid major differences between the interim and year-end figures, it is important that major accruals, depreciation and taxes be properly reflected.

Most of you have probably received monthly telephone requests from credit grantors in these trades, for "trial balance" figures. The accountant may accept a greater responsibility than he realizes, in submitting this data, and, in my opinion, these figures are often of doubtful value to the creditor. A trial balance, in the majority of smaller businesses, does not include accruals, month-end purchases, taxes, reserve for discounts, and other items which may materially affect the operating results. I believe it is better not to submit any information, than to submit misleading figures.

The telephoning credit agency often asks for the accountant's opinion as to the desirability of the credit risk. The accountant should furnish accurate figures, but it is the creditor's function to pass on the risk, and the accountant is ill advised if he assumes this additional responsibility.

Minimum Audit Program:

In the formulation of minimum auditing standards, lies the danger, that in attempting to so regulate the profession, we may remove the practitioner's independence of judgment or action. We must also realize that two auditors, each observing the same designated series of audit steps, will spend different amounts of time and achieve different results. It should therefore be understood that it is not the purpose of this paper to attempt to standardize the practice of public accountancy or to prescribe a uniform audit program for all clients.

In my opinion the following procedures represent the minimum we should do in the way of auditing, before submitting even qualified, uncertified, interim financial statements on our letterheads, in cases where credit grantors, trade sources or other outside interests will have access, directly or indirectly, to the figures submitted to the client.

You will note that some of the steps are purposely stated in general terms, since their scope and depth will vary in accordance with the degree of internal control, type of business, frequency of audit, etc.

It has been assumed that, since we are discussing monthly engagements, the auditor has previously reviewed the adequacy of the bookkeeping system and internal control.

(a) Reconciliation of bank balances, vouching of cancelled checks, and tie-up of cash receipts with deposits. (If a separate payroll bank account is maintained, reconciliation and test-vouching of payroll checks.)

(b) Count and reconciliation of petty cash if the fund or its activitiy is material. (If inconsequential, petty cash may be reconciled two or three times a year instead of each month.)

(c) Comparison of the totals reflected by accounts receivable and payable schedules prepared by bookkeeper, with the general ledger control account balance. Scrutiny and footing of schedules and test-ageing of larger receivable balances.

(d) Comparison of accounts payable balances with available creditors' statements.

(e) Test-vouching of larger bills for purchases of inventory, fixed assets, insurance, etc., and scrutiny of cash and purchase journals.

(f) Test-footing of selected columns of the cash, purchase and sales journals.

(g) Scrutiny of general journal entries.

(h) Checking of postings from journals to general ledger.

(i) Footing general ledger accounts and taking off a trial balance.

(j) If perpetual inventory records are maintained they should be scrutinized and test-checked. If no records are available, but the gross profit of your client is relatively stable, the gross profit test should be applied to any inventory figures submitted by the management.

(k) Preparation of workpaper adjusting entries for depreciation, unexpired insurance, taxes, expenses and salaries, regular year-end bonuses, discounts, etc., if not recorded in the books. (May I point out that there is little excuse for hastily prepared statements bearing a legend "subject to year-end accruals". That type of work will lead to difficulties with both clients and credit grantors. Also, in these days of high taxes, it is important that income, franchise, gross receipts and payroll taxes should be accrued. Do not submit a statement reflecting a "net profit before income taxes". This phrase is in itself a contradiction, since you cannot have a "net" profit without providing for all deductions.)

(l) It is probably not necessary to announce that certain lines of business are experiencing a slight recession. Especially for clients in those lines, it is important that the auditor scrutinize the adequacy of the bad debt reserve and the conservativeness of the inventory pricing. A small concern can fail rapidly; it is therefore necessary to maintain a close check on interim reports and not to await the year-end audit before setting up proper reserves.

Sampling and Internal Control on Non-Detailed Monthly Audits

By KERMIT J. BERYLSON, C.P.A.

THE need for a complete detailed audit is quite rare in the normal operations of large or small businesses. Although a client may often desire such an audit, this in itself does not necessarily establish a need. Where, however, a detailed audit is required by the client, and the fee which he is willing to pay is adequate to cover his requirements, such an audit may be made.

A business enterprise with a good system of internal control does not necessarily require a *detailed* audit of its transactions by independent public accountants. It must be recognized that some internal control exists everywhere, no matter how small the enterprise may be. Owner-review may often be more dependable, and more acceptable to accountants, than a review by employees. Further, bookkeeping machines and other equipment help office staff in double checking.

In the development of a program for an interim audit not of the completely detailed variety, the accountant must continually be aware of the system of internal control and audit, and the several bases for sampling tests to be made throughout the year.

It is basic that the scope of the audit must be predicated upon the comparative strength of the internal control system in effect, with appropriate recognition of the desires of the client. In order to reduce routine audit detail, to eliminate unproductive audit time, and to provide for important non-audit procedures, sampling methods must be introduced.

KERMIT J. BERYLSON, C.P.A., who is now engaged in practice in New York City on his own account, has been a member of our Society since 1939. He is a member of the Committee for the Furtherance of the Objects of the Society, and of the Monthly Audits Committee.

During World War II, Mr. Berylson served as a Lieutenant-Colonel in the Army. He was engaged in labor-relations activities for the Undersecretary of War, and as Quartermaster Stock Control Officer for the European Theater of Operations.

Mr. Berylson is the author of several articles on accounting matters, and is also a member of the Department of Accountancy in the School of Business and Civic Administration of The City College.

This paper was presented at a meeting of the Monthly Audits Committee on May 14, 1947.

The Theory of Sampling

The theory of sampling, which permits an auditor to apply this method to his work, is this: samples properly taken will provide the basis upon which a generalization may be predicated concerning the characteristics of the entire group. When samples are chosen with care, in such a way as to give each representative item an equal chance of being chosen, then the results of the detailed examination of the samples should indicate the general trend of all the items in the group being examined.

Audit test-checking is not necessarily statistical sampling. Sampling is applied on a scientific basis, while test-checking may not be. All too often, an auditor will select periods for a review of operations, or will examine sections of asset accounts, which can not provide a satisfactory picture of the client's affairs, or his methods of

doing business. For instance, if the A-D section of accounts receivable is examined, while all the large accounts are in N-S, then the accounts receivable test-check is not of much importance or validity. An efficient test audit requires the application of sound statistical methods.

In establishing an audit program for a non-detailed monthly audit, a choice must be made by the auditor with respect to the type of sampling which he will employ.

The following types of sampling are generally applicable to monthly audits:

Simple random sampling is normally used in statistical analysis when each item is found in equal proportion to all other items. The choice of the items must be so controlled as to give each item in the group an equal choice of being selected. (The word "controlled" is used to differentiate random sampling from the popular concept of the term "random" which implies a careless, hit-or-miss selection.) For example, in an audit of perpetual inventory records, each card should reflect the same internal procedure and, accordingly, those selected for review may be selected at random.

Stratified random sampling may be employed where there are certain known characteristics of the group. Accounts receivable are a good example of the type of data to which stratified sampling may be applied. The accounts are divided into dollar groupings. All of those above $1,000 are examined, 50% of those between $500 and $1,000 are examined, and 25% of those between $100 and $500, etc.

Again, sampling may be *purposive*—that is, only certain items are selected for sampling purposes. For example, an auditor on an annual engagement might choose the first, fourth and last months of the year for detailed review, because of his belief that these are important periods, and will provide him with essential information.

On an engagement the auditor is further faced with a selection between "*unit-item*" sampling and "*unit-period*" sampling. The former method would be used where an examination is made of an account which is static in terms of time as, for example, accounts receivable, inventories, investments, etc., which exist in a definite amount at a definite time. If days were stacked side by side, the sampling would consist of a vertical slice through one day. The unit-period method of sampling is generally applicable to those accounts which *move* through a period of time—for example, income and expense accounts, which have a constant growth from the beginning to the end of a period. The sampling slice here would be horizontal.

Examining Internal Control Methods

The nature of the audit program and the extent of the sampling to be applied is dependent upon the system of internal control which exists in the enterprise. The extent of sampling should vary inversely with the effectiveness of the system of internal control in effect. The better the control, the fewer the samples which need to be taken by the accountant. The interdependence of sampling and the value of the internal control system can not be under-estimated.

In checking internal control on a non-detailed monthly audit, the auditor is well advised to make use of an internal control check list. By the use of a check list, assurance is given that the transactions of an enterprise are reviewed periodically. The lists indicate, by specific questions, the steps which should be present in a complete internal control set-up and require yes or no answers. Although staff accountants may be competent, it is highly possible that some of the many details of internal control may be overlooked on an engagement, and the nature of the check list questions and answers will indicate immediately where sampling may be

safely applied and where it should be carefully considered. Comprehensive check-lists as described are available in several publications, and may be adjusted to fit individual cases.

The check list should be so subdivided that all of the prescribed procedures are reviewed *at least* once each year and more often, if changing situations in the client's office so warrant. The internal control review should be co-ordinated with the sampling applied on the engagement. Where it is found that the internal control procedures have not been maintained properly or where the sampling discloses errors indicating an unsound condition, then an extension of the sampling to an extent of even 100% may be warranted.

On a monthly non-detailed audit engagement, internal control may be reviewed as follows:

Item	Frequency of Review
(1) Cash and petty cash	Semi-annually
(2) Payrolls	Semi-annually
(3) Notes and Accounts Receivable	Annually
(4) Sales	Semi-annually
(5) Inventories	Annually
(6) Purchases and Expenses	Annually
(7) Notes and Accounts Payable	Semi-annually
(8) Investment Securities	Annually
(9) Fixed Assets	Annually
(10) Capital stock, etc.	Annually
(11) General Review	Annually

The Establishment of Sampling Quotas

In establishing the extent of sampling, the first step must be a complete review of all internal control procedures to determine existing weakness in the system. It must be understood that where adequate internal control does not exist, there must be heavy reliance on "faith", if sampling procedures are to be followed. Often enough, the accounting staff of a client on a monthly audit basis is quite small. In such instances, if it is necessary to apply sampling, the auditor's discretion must be stretched to the utmost in the determination of the safety factor point. In establishing the extent of sampling, increased audit emphasis must always be placed on uncontrolled transactions.

When error is discovered in audit samples, the auditor cannot assume that the type of error discovered will appear in similar proportions in those transactions which were not sampled. For example, suppose that in the process of test-checking, the auditor discovers a certain percentage of error in vouchers payable—let us say that in the three months out of the year, selected for sampling, a total amount of vouchers payable of $100,000 was entered and that there were 100 vouchers in the period. If errors totaling $3,000 were found on two vouchers, the auditor cannot conclude definitively that there was a 3% error in the total amount of vouchers payable throughout the year, or that errors appear on 2% of the total physical numbers entered during the year. The discovery of error in the sample can only indicate to the auditor that further examination may be necessary of the transacations not reviewed. Errors discovered, as in the foregoing instance, may represent a trend—and then again they may not. Accordingly, a more complete review of that category of transactions, in which the errors were disclosed, is called for. In auditing, there is a definite restriction on the statistical theory that random samples indicate the characteristics of a group.

Again, samples to be examined may be further restricted by determining that point at which error becomes significant. Any sampling of transactions then may be further stratified by a disregard of minor transactions. For example, where vouchers payable average $500, it might be assumed that any voucher up to $50 will not be significant in the operations of the company. Accordingly, most of such vouchers are ignored in the sampling process. Only enough of them are reviewed to provide for an over-all audit.

"Purposive" sampling is generally utilized on yearly examinations. For

example, the first and last months may be examined in order to detect fraud committed or covered up in those periods, or the periods of greatest activity may be examined. This same procedure may be applied on a monthly engagement. Sales may be examined in detail for only one month out of three. However, if sales are most active in the middle period of the month, then the sales for two months out of three may be examined, but for only the middle two weeks of each of those two months.

If it is possible to pre-determine the total number of possible errors in any group of transactions, application may then be made of the percentage of economic random samples which were developed by Mr. Prytherch and which were presented by him in the *Journal of Accountancy* for December, 1942.

There follows a table of my suggestions for samplings in a moderate-sized enterprise.

Item	Method	Percentage Check	Months of Examination
Deposit Slips	Unit-Item	15-40%	All
Cancelled Bank Vouchers	Unit-Period	100%	All
Bank Reconciliations	Unit-Period	100%	All
Cash Expenditures	Unit-Period	100%	Jan., Apr., July, Oct.
Bank Statement	Unit-Period	100%	Feb., May, Aug., Nov.
Receivables	Unit-Item	10-50%	Each Month
Payroll	Unit-Period	100%	Mar., June, Sept., Dec.
Inventories	Unit-Item	5-20%	Each Month
Investments and Income Therefrom	Unit-Period	100%	June, Dec.
Payables	Unit-Item	10-50%	Each Month
Purchases and Expense Vouchers	Unit-Period	100%	Alternate months
Sales and Return	Unit-Period	100%	Alternate months
Footings and Cross Footings	Unit-Item and Unit-Period	100%	Jan., Apr., July, Oct.
Postings	Unit-Item and Unit-Period	100%	Feb., May, Aug., Nov.
Fixed Assets	Unit-Period	100%	June, December

Sampling on a monthly engagement may be made a perfectly feasible operation. However, in order to introduce this audit method, the accountant must make every effort to introduce a complete system of internal control, and must review his sampling procedures to insure that errors of weighting do not creep into his test-check selections.

Some Aspects of Cycle Billing

By George A. Greenberg, C.P.A.

Cycle billing is, in essence, a procedure in which statements to customers are prepared and mailed on a stagger system, and in which customers' accounts are posted only once each cycle period. This is not a new concept. For many years, some public utilities, banks and similar large institutions with numerous customers, have employed this procedure to avoid end of the month peaks in the preparation of customers' statements and resulting peaks in collections and bookkeeping work. Within the last few years, the concept of cycle billing has been adopted by many establishments. For example, retail selling organizations and department stores have begun to utilize cycle billing in connection with their accounts receivable and credit departments.

The growth of the use of cycle billing was accelerated by the manpower shortage during the war years, and the increase in sales volume in the post war period. There is also the ever present desire to improve customer relations by more expeditious credit procedures, and more accurate and efficient handling of customers' accounts. The need for such a system will become even more pressing in the future. There is a growing demand for consumer goods, and the practice of buying on credit is becoming more widespread with the lifting of government regulations and the decrease in the "ready cash" buying power of the average family. As radios, washing machines, refrigerators, furniture and other heavy consumer goods become available for sale, the accounts receivable and credit rosters of the department stores will grow even further. Ex-servicemen who do not have sufficient savings with which to purchase these items, and the average family which does not desire to dissipate its war time savings or cash in war bonds, will tend to make these purchases on credit. With the increase in the availability of consumer goods, and the resulting sharpening of competition, management is also reminded that costs must be trimmed to aid in profitable operations. The proponents of cycle billing claim that this method cuts costs because less floor space is needed for equipment, personnel is reduced, and in addition, many skilled, high-priced employees are replaced by less skilled employees.

Before attempting to evaluate cycle billing and to discuss audit procedures in this connection, it is necessary to indicate the structure of a typical cycle billing installation. In a department store which uses this method, the charge accounts receivable are divided into cycle groups, based on an alphabetical breakdown, and each cycle group is controlled separately. Billing dates are assigned to each group and are spaced evenly throughout the month. When an account is opened, a complete customer's file is prepared. This includes a customer's transcript card which provides space for the customer's name, address, references, credit limit and signature. The card is also a ledger card in that it provides for the posting of the total sales, credits and cash payments for each cycle period and for the balance after the total postings are made. Attached to each card is a pocket-like arrangement in which the sales, credits and cash payment tickets are filed. After completion, the card is assigned to a cycle group, and is filed among this group of customers' accounts in alphabetical order. The card is also assigned a control group number to facilitate filing of materials. Each customer is supplied with an identification plate, which includes the control

George A. Greenberg, C.P.A., has been a member of our Society since 1945. He was graduated from The College of the City of New York in 1938. At present he is on the staff of Klein, Hinds & Finke, C.P.A.'s.

number, and which is stamped on each sales ticket by the sales clerk.

The daily sales tickets and credit tickets are sent to the sales audit department and are processed in the usual manner. Daily totals are accumulated according to sales clerk and department, and the tickets are then analyzed and totalled as to type of sale, as, for example, charge, cash, C.O.D. or layaway. After this is done, the charge sales and credit tickets are separated into their respective cycle groupings and are fine sorted into alphabetical arrangement within each group. Adding machine tapes are taken of each group and the totals of these are compared with the figures as determined on a store-wide basis by the sales audit. The tickets and adding machine tapes are then sent to a control desk, and the control clerk posts the daily totals of sales and credits to cumulative ledger control sheets for each cycle group. Daily combined totals of all cycle controls are balanced with the storewide daily totals to prove that all tickets were received by the control clerk. After the totals have been proved, the tickets are distributed to the account clerks and are stuffed into the respective customers' control pockets.

Cash receipts are handled in substantially the same manner. The section of the customer's bill which is supposed to be returned by the customer with the payment, is used as a cash ticket. If the customer does not return this ticket, the cashier prepares one. The ticket indicates the customer's name, address, cycle control number and amount paid. At the end of the day, the cashier separates these tickets into their various cycle control classifications. The tickets are arranged alphabetically within each cycle group and are totalled on an adding machine tape. These are sent to the control clerk who records the total collections on the cumulative ledger control sheet for each cycle group. The total of such postings on the control cards is compared with the cashier's daily report to prove that the control clerk received all cash payment tickets. The tickets for each cycle group are then distributed to the account clerks for stuffing into the customers' file.

Where errors in sorting or filing are detected, a transfer slip is prepared indicating the control in which the ticket appeared, and indicating the control in which it should be filed. The transfer slips are sent with the misfiled tickets to the control clerk, who makes the appropriate entries on the control cards for the cycles in question, and gives the tickets to the account clerks for correct filing.

As the clerk places sales, returns, and cash tickets into the customers' file, she sets visable, movable signal tabs on each card which indicate the approximate balance of the account up to the last ticket filed, and an ageing of the unpaid balance. In this manner, the credit department has current information available to assist in determining individual credit procedures.

At the end of each cycle period, the addressing department prepares bill heads for each customer in that cycle group from addressograph plates which were prepared when the accounts were opened. The customers' transcript cards and posting media (sales, credit and cash tickets) are removed from the account pockets and are stacked in sequence beside the billing machine operator for posting. Every account on which the transcript ledger shows an unpaid balance, or for which there are posting media in the pocket, is pulled. The pre-addressed bills are placed next to the transcript cards, and stacked in the same sequence. If a bill has been missed or a change not made by the addressing department, the machine operator inserts a blank bill form, types the heading from the ledger and proceeds as usual. The appearance of a typed heading on the proof journal is a signal to have the addressing plate ready for the next billing.

The billing machine operator places the customer's bill and the transcript

ledger side by side in the machine. She picks up the old balance from the ledger card and enters it on the bill. She then enters the money amounts of all sales, credits and cash payments on the bill in the appropriate columns from the posting media. The machine automatically totals these items, brings down the new balance on the customer's bill and then swings over to the ledger card and enters the cycle period's total sales, credits and cash payments, and records the new balance. While this operation is in process, the machine is accumulating classified totals of old balances, sales, credits, cash payments and new balances. After all accounts in the group have been billed, the machine is cleared, and the total of the account balances is compared with the balance as shown by the cumulative control ledger sheet. Errors in posting can be localized by comparing the opening balances on the proof journal to the closing balances of the previous month's journal, and by comparing the totals of sales, credits and cash postings as recorded on the billing machine's tape to the totals as posted on the cumulative control ledger sheet.

After this operation is completed, the bills and posting media are photographed on microfilm. The original tickets are attached to the bills and sent to the customers' and the customers' transcript cards are replaced in the files.

Is cycle billing a passing fad born of war time necessity, or is it an innovation in accounting procedure which has merit and which will become a permanent addition to modern record keeping? This is not a question of fact, and cannot be answered by yes or no. However, we can form an opinion by comparing some of the advantages and disadvantages of cycle billing and by taking cognizance of what management thinks of it. If the use of cycle billing continues and becomes more prevalent, the independent public accountant will encounter this system more frequently and it is incumbent upon the accounting profession to establish accepted and uniform procedures and terminology for the verification of accounts receivable handled in this manner.

Many articles have been written about cycle billing installations by representatives of department store management in the *Bulletin of the National Retail Dry Goods Association* and similar publications. In the majority of the articles which have come to our attention, the writers have been enthusiastic about their experience with cycle billing in their own stores. Many of them insist that cycle billing is a desirable operation for small as well as large stores. The following are some of the more salient advantages of cycle billing, upon which most of the writers are in general agreement.

The work of the bookkeeping, cashiering, collection and credit offices is spread over the entire month. End of the month congestion and confusion in balancing all the ledgers and mailing all the statements is eliminated. Due dates of bills are spread over the month, which means a more even flow of payments into the cashier's office. Bill claims are reduced because the customer gets the original sales ticket with the bill. Whatever bill claims do arise are distributed over the month. Fewer employees are required and scheduling of work is simpler. In most instances there is a material reduction in the costs of operation of the bookkeeping, cashiering and mailing departments. Mailing of advertising material with bills throughout the month affords more uniform customer traffic to selling departments.

Balanced against these advantages are several objections which may be raised. Unlike ordinary systems, the posting media are not entered on the customers' accounts day by day but remain in the customers' files until the end of the cycle period. Therefore, if a ticket is lost or removed from the files after stuffing, such loss may go unnoticed until the end of the cycle period when it is more difficult to trace. Many installations minimize this possibility by

assigning trusted employees to the files and by setting up several cumulative controls within each cycle control. Where a punch card system is used in the sales audit in conjunction with cycle billing, missing tickets are traced very quickly. Objections are also encountered because considerable expense is involved in the purchase of new machines, in the changeover from the system formerly employed and in the training of personnel in the new system.

The next two objections are of particular importance to the auditor. Examination of the accounts is made more difficult because it is not feasible to obtain a detailed listing of all the account balances as of audit date. Secondly, there are some instances in which a current payment does not pay off the total previous month's balance. The account cannot, therefore, be aged properly because each customer's card shows only the totals of sales, payments, etc., for the cycle period, and the balance may include an old, unpaid charge. The latter two objections will be discussed more fully in the following paragraphs which will be concerned with audit procedures in connection with cycle billing.

It is not practicable to set forth in any one program, procedures which will fit the varying situations encountered on different audits. The extent to which the suggested steps are to be performed must be determined by the independent public accountant in line with the conditions in each individual company. By an examination of the system of internal control of the company under examination, the auditor should determine the extent of each procedure. An examination of the system of internal control in connection with cycle billing is of paramount importance, since some of the accepted procedures in the verification of accounts receivable have to be altered because of the nature of cycle billing.

The following are some features of internal control which will assist the independent accountant in determining the extent of the work to be done in verifying the accounts.

1. Customers' files should be under the supervision of the account clerks directly responsible. The files should be locked when not in use. If possible, the files should be kept in a cage or partitioned portion of the office. This is important since the files contain unposted media which are difficult to trace if lost.

2. Customers' files should not be accessible to persons other than the responsible account clerk unless in the presence of the account clerk or the department supervisor. Certain employees, especially the cashiers, adjustment clerks and incoming mail clerks, should not be allowed to handle customers' less, except when absolutely necessary, and then under the supervision of the responsible account clerk.

3. There should be segregation of duties. The account clerks should not be used in any capacity in the cashier's, adjustment and incoming mail departments, and employees of other departments should not be used to assist the account clerks.

4. Employees' accounts receivable should be segregated into a separate control. These files should be under the supervision of trusted employees.

5. Daily totals of sales and credits are to be calculated by the audit department, and cash receipts totaled by the cashier. These should be compared to the totals as posted to the summary controls in the accounts receivable department by a person not directly connected with these departments.

6. Numerical sequence of sales tickets should be checked and regular accountings for all missing tickets made.

7. Credits should be issued only by responsible personnel and unused credit books are to be controlled by employees other than those issuing or processing credits. In no case should blank credits be available to the account clerks or cashiers. Credits should have proper authorization and should also bear the signature of a merchandise receiving clerk or an adjustment clerk.

8. Authorization for customers' charge sales should be under proper supervision and the store's credit policies should be consistently applied.

9. When bad debts are written off, it should be determined that the action has been approved by responsible authority.

10. Discounts should be properly authorized.

The foregoing is by no means an all inclusive itemization of proper internal control procedures. Conversely, the absence of any of the above controls in an installation does not mean that the system is not adequate. The purpose of mentioning these procedures is to indicate the general line of approach in determining the extent of the auditing work.

Where the company under examination has internal auditing procedures and an internal auditor, the independent accountant should inquire into the extent of such work, and scrutinize the internal audit programs and the reports of the internal auditor. This may indicate to the independent accountant the adequacy of the system. In any case, the independent accountant should prepare a summary of differences between all of the cumulative ledger control balances and the balances billed at the end of each cycle period for the year. An inquiry as to what attempts were made to determine the cause of these differences and their disposition may indicate points of weakness which then may be investigated in more detail.

The following are suggested steps in connection with the audit of accounts receivable in a cycle billing installation.

1. Examine the system of internal check and control. A questionnaire may be used to compile this information in logical order. The information required may be gathered from discussions with the management and employees and observation of some of the store operations. Make tests of the accounting records to determine whether such controls are being carried out (proper approvals and signatures on sales credits, approvals of bad debt write-offs, etc.).

2. Summarize cumulative ledger control totals and reconcile with the general ledger balances at balance sheet date. Adjust for differences.

3. Obtain lists of customers' balances open at dates nearest to the end of the year with the amounts classified according to age. In this connection, such lists may be for cycle periods for the month up to the last day of the year, or may consist of cycles billed from the fifteenth of the last month of the year to the fifteenth of the following month. Foot these lists and compare them with the customers' accounts in the files. Note on the lists amounts paid since the last date that the particular cycle was billed. This is done by the examination of unposted media in the customers' file. Ascertain that returns subsequent to billing dates are normal. Compare the totals of these lists with the cumulative controls for each ledger at billing date.

4. Examine the composition of outstanding balances. This step may present a problem since postings of sales, cash and credits are made by cycle period totals. If a previous month's balance is not completely paid by a subsequent month's remittance, and this situation continues for several months, it may be impossible to determine the composition of the account by scrutiny. If it does not involve material amounts and the account is active and is being paid currently, it may be safe to assume that current payments are being applied against the earliest charges. However, if this situation is widespread and occurs frequently and indicates that there may be substantial old unpaid items in the accounts, it may be necessary to have the management refer to the film records to reconstruct some of the larger of such accounts for more detailed scrutiny. Discuss disputed items and accounts that are past due with the credit manager, or with some responsible officer, and make such inquiries as are deemed necessary in

order to form an opinion of the worth of the accounts and the sufficiency of the reserve for bad and doubtful accounts.

5. Ordinarily, correct procedure dictates that customers' credit balances be included among the liabilities on the balance sheet. In a cycle billing system, such information may not be available since there is not a detailed listing of all customers' balances as at any one date. Where this information is not available, scrutinize various account listings or proof journal analyses for cycles billed during the year, and especially for cycles billed close to the end of the year. If such scrutiny reveals that credit balances are unusual and not material in relation to the total of the accounts receivable, the auditor, for practical reasons, may not be concerned about attempting to segregate these credit balances. If scrutiny of accounts and other inquiries lead to the belief that the credit balances are material, proper disclosure should be made in the audit report. Investigate the reasons for large credit balances.

6. Determine that correct "cut-offs" have been made on lay-away, C.O.D. hold and similar accounts and ascertain, that if these accounts are included in the accounts receivable, that the merchandise was excluded from inventory. Determine that payments are being made currently on these accounts. If accounts of a material amount, including installment sales accounts, mature later than one year from the date of the balance sheet, they should be shown separately thereon unless it is not practicable to segregate the portion maturing beyond a year. In that event, the balance sheet should carry an explanatory note. Appropriate note should be made on the balance sheet for accounts hypothecated, assigned or encumbered in any manner.

7. It is sometimes not necessary to segregate accounts receivable which are due from employees, officers, directors and stockholders which arise from ordinary and current sales of merchandise. However, there may be circumstances, such as special means of payment, larger credit authorizations than ordinarily would be given, etc., which may indicate that these accounts should be segregated. If this is so, and it is not practicable to make such segregation, appropriate comment should be made on the balance sheet.

8. Confirm the accounts by direct communication with the debtors. The method, extent, and time of confirming the accounts, and whether all of the receivables or a part thereof are to be confirmed will be determined by the judgment of the independent accountant. Cycle billing affords no problem in this respect. It is not necessary, in all cases, to confirm the balances of all of the accounts as at balance sheet date, and procedure will vary according to the engagement. Depending upon the circumstances involved, test circularizations of the accounts may be done during the year; balances at cycle dates nearest the balance sheet date may be confirmed; or verification may be requested on accounts being billed on cycle dates ending during the course of the examination.

Mention has not been made of all the procedures which are sometimes used in the examination of accounts receivable, since many of them are generally applied and do not relate specifically to the audit of accounts receivable in a cycle billing installation. Steps such as comparing sales invoices with shipping records to ascertain that merchandise was shipped prior to closing, scrutiny of sales for padding, and others, should be taken, whether the accounts are on cycle billing or any other system. In addition, the points covered in this article are not intended to comprise a thoroughly comprehensive study of cycle billing or of the audit procedures connected therewith. They are set forth, rather, as guides which may be useful in understanding the nature of cycle billing and the problems involved in the audit of accounts operating under that system.

The Audit of Accounts Payable

By Robert S. Moss, C.P.A.

Any discussion of the "audit procedures applicable in the circumstances" preparatory to issuing a certified balance sheet, must take into consideration certain recurring conditions which surround the year-end audit and influence its approach, scope and execution.

The foremost of such conditions is pressure: pressure from the client to issue a report as promptly as possible; pressure from Uncle Sam to file a tax return within 75 days of the end of the client's fiscal year; and pressure from within the auditor's own organization to conclude each audit rapidly so that all clients will get adequate attention during the rush season.

A second condition is that the client's office staff and records are usually not completely prepared for audit, although the client is pressing the auditors to begin. Files are frequently not available or up to date, schedules and analyses essential to the auditor are often not prepared in advance by the client or are prepared in a form difficult to audit. The client's staff, in recent years, has usually been under strain, making it difficult for them to provide the auditors with essential assistance and cooperation at the time of the audit, because of the need to close the books of one year and open those of another, while keeping abreast of day-to-day work and getting out detailed reports for management.

A third factor the auditor must reckon with, which may upset a standard audit program, is unavailability of data. Whether it be that the required records are located at distant plants, or have been stored in the vaults and cannot be located, or are in constant use by the client and are not readily available to the auditor, or have simply been misfiled, some required record may not be available to the auditor thus requiring a shift in audit plans.

Another restricting circumstance is that on many large audits the sheer volume of work involved makes difficult, if not economically impossible, the preparation of desirable detailed schedules by either auditor or client.

The preceding factors all have a bearing on the scope and execution of the audit program; and in order to satisfy the requirements of accepted audit procedure, establish and maintain adequate control over the audit, eliminate procedures of questionable value, and interfere as little as possible with the client's office procedures, the auditor will find that no single standard audit program, however general, can be applied to all audits or to all businesses. On frequent, detailed audits of smaller concerns, where the auditor is an integral part of the system of internal control, procedures are feasible (and are desired by the client) that are impractical or undesirable on larger assignments where the client has his own accounting and auditing department and desires the outside auditor to do the minimum necessary to render an opinion on the financial statements. An effective audit program must reckon with the fact that each client is different and that every good audit is a "custom-made job", designed to fit the respective client's records and individual needs.

Robert S. Moss, C.P.A., is a member of the New York State Society of Certified Public Accountants and of the National Association of Cost Accountants. He is a graduate of The City College (New York) School of Business and Civic Administration, and has had extensive public accounting experience, including systems work. He is presently associated with Eisner & Lubin.

One of the essential and frequently difficult portions of a balance sheet audit of the larger corporation is the verification of trade accounts payable. Business machines and techniques of handling vendors invoices, tend to complicate the accounts payable audit. Three-and four-part check vouchers, voucher registers and check registers, are becoming the rule of the day. Nevertheless, "Vouchers payable", "Accounts payable not vouchered" and "Unaudited bills" must be reckoned with by the auditor on the larger examinations as effectively as he deals with the relatively simple accounts payable ledger on the smaller examinations. On these larger audits, he must deal with masses of documents, changing daily, and frequently with only an adding machine tape or a comptometer operator's report to substantiate a total. To determine the aggregate liability to a given vendor, the auditor may have to refer to four different categories of bills controlled by four different clerks who have little or no awareness of each other's function. Another uncertainty arises from the fact that many clients unfortunately do not request statements from their creditors, nor keep those they do receive. Increasing accommodation purchases by clients on behalf of their suppliers (a contemporary by-product of scarcity in our expanding economy), sometimes handled as offsets to purchases, other times treated as trade receivables and handled independently of the purchase aspect, introduce another element into the confusing picture. As the corporation grows in size and the handling of bills becomes more departmentalized and mechanized, the number of possibilities for error, fraud and defalcation increase in direct proportion to the volume of work, the number of clerks involved and their relative competence and training. As the size of the business grows, so does the urgent need for effective internal control, which in the last analysis, must be the keystone in the arch of reliability for both client and aduitor, for which there is no substitute.

The problem of testing internal controls in the accounts payable department and arriving at a figure for inclusion on the certified balance sheet as a reasonable estimate of accounts payable at a given date can be solved by a variety of audit procedures. A discussion of some of these follows:

Schedules:

The usual starting point of the accounts payable audit is to secure from the client schedules showing the composition of the recorded accounts payable, indicating the various creditors and the balances due each. This schedule should, of course, be reconciled with the general ledger control by the auditor and the footings verified. At first glance, this seems to be a simple procedure, and on the smaller audits the preparation and checking of this schedule usually is not complicated.

The total liability to each creditor is listed on a schedule which is supported by an accounts payable ledger to which the auditor can compare the balances on the schedule and from which he can secure the detailed composition of the balances.

In the case of larger clients, using a voucher system and keeping no subsidiary ledger, several more complicated schedules are usually necessary. Salesmen of modern business machines have devised many ingenious methods of adapting their machines to solving the problem of performing in one operation the dual function of first recording a bill as a liability and an expense, and secondly, recording its payment. These methods are accepted by clients in the interest of economy; but the one thing most of them have in common is that it becomes a rather complicated procedure to determine the composition of the accounts payable controls. The author has found that the four types of schedules set forth below will usually be adaptable to most

machine systems of recording accounts payable, provide workable audit schedules, and conform to the standard documentation for certified audit purposes.

1. The major category of recorded liabilities usually consists of "vouchered" bills; that is bills which have been processed for extensions, prices, etc., but which have not been paid as at the audit date. (These bills usually are fastened to the respective vouchers and filed together with the supporting documents.) The schedules listing these recorded bills should show creditor's name, voucher numbers open for each creditor at the audit date, total liability for each voucher, as well as the total liability to each creditor for vouchers of this category.

2. The next largest category of recorded liabilities usually consists of bills not vouchered; that is bills predating the audit date, which were not processed by the client's staff prior to the audit date, and which are frequently recorded at the end of the period by a journal entry. The schedule recording these bills should show the creditor's name, the individual invoices open (dates and amounts), the general ledger account ultimately charged for the bill, and, where possible, the number of the voucher on which the bill was ultimately recorded.

3. Inventory in transit usually gives rise to unvouchered or unrecorded bills, and the schedule recording these items is usually similar to the one outlined in item 2 above, but should show in addition the date the merchandise was received, and the receiving report number.

4. Unrecorded liabilities disclosed by the auditor will usually be tabulated on a schedule similar to those discussed in 2 and 3 above.

Vendors' debit balances are sometimes carried as accounts receivable on the client's records, but more frequently are included as red balances on the liability schedule. When the client segregates these balances on a separate schedule, all sizeable amounts of such nature should be compared with the various accounts payable schedules discussed above to ascertain that there are no offsetting liabilities outstanding to the same creditors, against which the charges will ultimately be applied.

Whatever the nature of the accounting system used by the client, the auditor should attempt to secure or prepare appropriate schedules whose adequacy can be measured against the following criteria: (a) They should provide an analysis of the composition of the amount to appear as "Trade accounts payable" on the certified balance sheet; (b) They should provide an analysis of the balance of each control account on the general ledger for accounts payable, or whatever nature; (c) It should be possible to determine from the schedules the aggregate liability to each creditor, for comparison with confirmations; (d) The schedules should be comprehensible to an accountant other than the one who prepared them; (e) The schedules should be suited to the accounts payable audit program and permit easy compilation of data for any necessary adjusting entries. These schedules are the foundation upon which the accounts payable audit is built, and the auditor will usually find it desirable to collaborate with the client in advance of the audit on the manner in which the schedules prepared by the client are to be set up.

Confirmation by Correspondence:

The second phase of an accounts payable audit is the preparation and mailing of requests for statements to the client's creditors, asking that the replies be mailed direct to the auditors.

This is one of the most important and effective audit procedures, if properly planned and executed. The primary purpose of direct confirmation is the testing of the correctness of the client's representations and the effectiveness of the internal controls.

The auditor must determine in each audit how broad a scope to give his confirmation program. He is interested in verifying that the schedules submitted to him by management reflect the correct liability to the creditors listed thereon, and that all creditors appear on the list.

What form the request for confirmation should take is a subject on which there are many views. Some larger firms stock forms printed in large quantities, on which the client's name and address is rubber stamped in the space provided. Other firms print or mimeograph special forms for each audit on the client's letterhead. It seems preferable to use the client's letterhead, since a creditor may object to disclosing confidential information on the basis of a rubber stamped form.

A specimen form letter, found efficient, is presented below:

Creditor
Address

Gentlemen:

In connection with the regular (annual) examination of our accounts, our auditors, Messrs..... ...., (address)....... ......, desire confirmation of the balance in our account with you as at (audit date)....................

We would appreciate your mailing them a detailed statement of our account at the above date, indicating separately items represented by notes. Please mention if any amounts are secured and indicate the security held. Also show any items shipped but not billed, or shipped on consignment, dating or memorandum.

May we also request that you advise our auditors of the quantity and dollar amount of any firm commitments for future delivery.

A stamped self-addressed envelope is enclosed for your convenience.

Very truly yours,
NAME OF CLIENT

The confirmations should be mailed by the auditor, personally, in envelopes bearing his return address.

With respect to verifying the recorded liabilities, the adequacy of the client's system of internal control (Are statements normally requested before making payment? Are adequate purchase and receiving records and inventory control maintained? etc.) has a bearing on whether the auditor will attempt to confirm all liabilities by correspondence or resort to a test check. If a test check basis is used, in choosing his sampling the auditor should bear in mind that fraud will manifest itself not only by incomplete disclosure of all liabilities, in the instance of a client trying to show an unwarranted favorable current position, but also by distortion of liabilities arising from more complicated and fraudulent devices, as in the McKesson and Mergenthaler cases. Hence, an adequate test check should pay equal attention to large and small balances, and adhere to the principles of a random sample.

In attempting to ascertain the existence of unrecorded liabilities, the author has found it effective to scan the client's paid bill or voucher files and note vendor's accounts which reflect substantial activity, but no year-end balances, and send requests for confirmation to them as well as to the vendors whose accounts reflect balances at the audit date.

If the random sample method of confirmation is being used, record should be kept of those vendors to whom requests for confirmation were sent, and second requests should be sent where desirable when the first is not honored.

When the confirmations are returned, the amounts recorded thereon should be compared in detail to the accounts payable ledger and/or the balances recorded on the schedules discussed previously in this article. Differences should be carefully reconciled and note made for discussion with management of any deficiencies disclosed in internal controls. All sizable differ-

ences should be scheduled, explained, and, where proper, adjustments recommended. It is at this stage of the audit that careful preparation of the schedules referred to above yield the most dividends and eliminate duplication of effort for if they were properly set up, it will be possible to note thereon the amounts confirmed, the differences disclosed, their explanation and disposal in a form readily adaptable to summarization. One of the results of the confirmation program should be data as to (a) the number and percentage of confirmations returned to those mailed; (b) the percentage of total liabilities for which confirmations were received to total liabilities for which requests for confirmation were sent; (c) the differences disclosed by the confirmations received. If the confirmations were sent on a test basis, the auditor should consider the total estimated differences which would have resulted from a 100% confirmation program based upon application of the figures resulting from item (c).

A specimen schedule, to accumulate the above date, is set forth below. (The first five columns should be prepared by the client, if possible, and the remaining columns completed by the auditor.):

1) Vendors' names
2) Voucher numbers

Recorded Liabilities:

3) Vouchered
4) Not vouchered
5) Total
6) Balance per confirmation

Differences:

7) Confirm over
8) Confirm under

Disposition of Differences:

9) Inventory in transit
10) Unrecorded expenses:
    Account
    Amount
11) Explanations

Vouching:

In determining to what extent the auditor will vouch the outstanding liabilities to the individual invoices at the audit date, consideration must be given to the period and extent of vouching done under the cash disbursements-voucher register aspect of the audit program and the extent and results of the accounts payable confirmation program. An extensive program of vouching for a period overlapping the audit date in connection with the cash audit program, and satisfactory replies to extensive confirmations may satisfy the auditor and lead him to feel that only a test vouching of outstanding liabilities is desirable. However, whatever the criteria used by the auditor in determining the extent of vouching necessary, the program should be sufficiently broad to determine that there are adequate internal controls in constant use, that there are proper purchase orders and receiving reports, that prices and extensions are verified and discounts taken, that possibilities for collusion are minimized, and that the schedules of open liabilities submitted by management are reliable.

Cut-Off:

Another essential aspect of a comprehensive accounts payable audit program is the verification of cut-off. Some auditors will consider this procedure as part of inventory verification; others as part of the audit of accounts payable. It is an integral part of both, and should be so devised. A good cut-off test should answer the following questions: (1) Have all liabilities been recorded for merchandise received prior to the audit date? (2) Was merchandise received and inventoried for all liabilities recorded prior to the audit date? (3) Are receiving records adequate and properly maintained?

It is usual to approach this problem on a test check basis, using the accuracy of the results as a guide to the need for more extensive tests. This procedure should be done in two phases, one

a test from the receiving records to the purchase and liability records, and the other a test from the purchase and liability records to the receiving records. The period of test should overlap the inventory date in both directions. For the first procedure, a sampling of items within the test period should be listed from the receiving records showing date received; receiving report number; vendor; quantity and item received. After these data have been tabulated, they should be compared with the purchase record and invoices to see that invoices were recorded for all merchandise received. The schedule should be completed by recording thereon the invoice date, amount and the voucher number or purchase record folio on which the invoice was charged.

The second procedure should be exactly the reverse. The first listing of data should be abstracted from the purchase or voucher records and then traced to the receiving records from which the date of receipt, report number and quantity can be obtained.

It might be desirable to emphasize at this point that the auditor cannot be too careful with respect to establishing the adequacy and accuracy of receiving records. It is one of the few ways of disclosing a fraud of the Mergenthaler type. While the above-mentioned cut-off procedures alone will not suffice to disclose defalcations of this nature, when used in conjunction with a vouching of disbursements or liabilities in which careful attention is paid to the supporting invoices and receiving reports, (which should be affixed to the respective invoices) the two procedures can satisfy the auditor that there are safeguards against this type of collusion.

Unrecorded Liabilities:

The procedures already outlined will usually serve to disclose to the auditor whether or not there are unrecorded liabilities in substantial amounts. The confirmations, vouching of liabilities, and verification of cut-off, each scrutinizes an aspect of internal control and will help disclose possible unentered items. However, there can be unrecorded liabilities which the preceding methods will not indicate, for instance, an unrecorded liability to a creditor, who did not respond to a request for confirmation and whose account was not verified by vouching of the bills. One device which serves to minimize this possibility, and which is usually practicable on audits when the examination is conducted during a period not too long after the end of the fiscal year, is to scan the unpaid and paid bill files for the new fiscal year for prior year's items. This procedure can usually be done rapidly and often proves effective in disclosing unrecorded liabilities, accruals, etc. A few questions directed to the various clerics involved will often suffice to inform the auditor what control there is over unpaid bills within the organization, and put him on notice of the possibility of lost or missing invoices.

Inventory in Transit:

One aspect of the problem of unrecorded liabilities, which frequently brings the auditor into debate with the client, is that related to inventory in transit. Many firms are neglectful in recording inventory in transit to the company and the liability relating thereto, and raise the argument that there is no liability since they have not received the merchandise as at the audit date, and have not included it in inventory. To this point of view, the auditor can only offer the fact that in most instances, when terms are F.O.B. origin, title passes on delivery to the common carrier. Where the auditor can ascertain that title has indeed passed, he should advise his client that there is a definite liability and that the inventory and liability should be reflected on the balance sheet.

Disposal of Differences:

In the process of executing the accounts payable audit program differ-

ences will arise, usually minor, occasionally sizable. If the various schedules have been properly set up, the auditor will be able to keep a record of his exceptions, for summation at the conclusion of the audit. Most clients object to being subjected to repeated questions on the same subject and it is frequently advisable to accumulate all differences to be disposed of in one conference. Before reviewing his exceptions with the client, the auditor should re-examine his notes from the perspective of the completed audit program and evaluate the volume and amounts of the differences disclosed by audit in relation to the total volume and amount of bills and liabilities. He should form an opinion on the adequacy of internal controls in the light of his exceptions, and decide whether he can accept the client's figure for accounts payable, or if he should recommend adjustments. In determining the need for adjustment, he will consider that his interest lies in a fair presentation of liabilities on the balance sheet.

Conclusion:

After discussing his exceptions with the client, the auditor should proceed to tie in his workpapers. A summary schedule should be prepared showing the individual amounts and totals of the various general ledger liability accounts to be grouped on the balance sheet as "Trade Accounts Payable". The working papers and schedules should be logically grouped, initialled, dated, indexed, cross-indexed, and bound with the summary on top. The detailed audit program stating all the procedures executed should be initialled by the individuals performing each step, and filed with the audit papers.

The papers, when complete, should indicate clearly what the scope of the audit was, how it was executed, what the exceptions were, how they were adjusted, and the composition of the accounts payable item reflected on the balance sheet.

Tax Accounting for Security Brokers

By Benjamin Grund, C.P.A.

It is interesting to note that security brokers as a rule do not confine themselves merely to acting as brokers. They are frequently a combination of brokers, dealers, underwriters, traders, and investors. They might also be regarded as bankers, in making loans to customers. They include in the scope of their operations, the entire gamut of property values, both domestic and foreign.

Approaching this subject from the balance sheet point of view, the first item we run into is Cash, which was amply covered in the paper recently presented by Max Rolnik on the subject of "Tax Accounting for Banks".

Cash or Accrual Basis

The next item we meet on the balance sheet is Accounts Receivable. This brings up for consideration the accounting basis employed by the security brokers. Are they or should they be in a cash or an accrual basis, or do they in fact employ both the cash and accrual basis? Hybrid methods of accounting are as frequently used by security brokers and security dealers as in almost any other industry. Ask a broker on what basis his books are kept and he will almost invariably reply that he is on a cash basis. Refer to his books and you will find, quite commonly, that they are kept on an accrual basis.

How do you account for his belief that he is on a cash basis? His cash book is kept open until all bills are paid. As far as receivables or accruals are concerned, we run into a mixed picture there as well. From a practical viewpoint it is difficult for a security brokerage firm to keep proper records that are not maintained on an accrual basis. If sufficient care is taken, they can keep their books on a cash basis; and, if they consistently maintain such records, the Treasury Department will accept them. As a matter of general practice, however, we find that most security brokers keep their books on an accrual basis, and our discussion will consider primarily the problems they have to contend with.

Benjamin Grund, a partner of a prominent national firm of Certified Public Accountants, is a C.P.A. of New York. In addition to affiliation with our Society, he is also a member of the American Institute of Accountants.

Mr. Grund has written and spoken extensively on the subject of taxation. He is a member of the Society's Committee on Federal Taxation and has lectured at the New York University Institute on Federal Taxation.

This paper was presented by him at a technical meeting conducted by the Society's Committee on Federal Taxation at the Engineering Auditorium.

Accounts Receivable

Reverting to accounts receivable, security brokers are allowed a reserve for bad debts. Such a reserve is not frequently used. But there is no objection to its use and to providing for bad debts through the reserve method. Security brokers will generally close out a customer's account soon after he is sold out if a debit balance is open after the proceeds of the securities have been applied against the open account. Such an account could be carried until an exhaustive determination is made whether it is collectible in whole or in part. As a general rule, however, if the customer's transactions are of such a nature that he could not respond to a margin call and it was necessary for his securities to be sold out, we will find almost invariably that the balance will

be written off. If something is realized later, it will be reported as a recovery of bad debts.

Presently there are very few partially secured accounts. The entire margin situation has been tightened up as a result of current banking rules. Undermargined accounts and partial write-offs are the rare exception under present conditions.

Brokers may have receivables from other brokers which generally are very current. But when another broker happens to "go through the wringer", the same principles that apply to a customer's account will apply to a broker. Normally we would ascertain very quickly how much will be realized. Accounts of a broker in financial difficulties are liquidated readily and there should ordinarily be no problem as to how much to write off and the year in which the charge off belongs.

Accrual of Commissions and Other Items

The matter of accruals, both of commissions and other items is the next subject for consideration. Let us first cover the accrual of commissions. In the case of an order executed on the New York Stock Exchange on a Friday, the security is delivered the following Wednesday, three full business days later. If between Friday and Wednesday we have the end of a month—as we had in December 1946, Tuesday being December 31st and Friday being December 27, a situation develops in which the order is executed in one year and the commission charged to a customer's account in the following year.

Some brokers have been accruing the commission on the day the order was executed, but before the transaction is completed. Others accrue the commission at the time the order is completed, when delivery of the security is made and the customer charged. The latter appears to be the better practice. Equally important is the need for observing a consistent practice.

In the case of transactions in commodities, commissions accrue upon the completion of the round turn; that is, when both ends of the transaction are completed. Until then, the commission is open. In the case of when-issued transactions, the broker does not defer charging a commission until the consummation of the transaction since he might never get paid if the transaction falls through. Accordingly, the commission is charged at the time the when-issued order is first carried out without waiting for the reorganization plan or other contingency to be completely disposed of. Situations also occur where a broker deals with another broker in when-issued transactions. The custom in such cases is not to charge the other broker with a commission, unless and until the when-issued transaction is completed. In dealings with the general public, however, the commission is charged immediately.

Commissions may be met in transactions of underwriters. Occasionally a company floats an issue of securities, which are offered to the public on the basis of allowing the underwriter a commission rather than an underwriting profit. In such a case the underwriter would not realize his commission until the underwriting is completed and the commission charged to the corporation floating the issue. In view of the doubts and exigencies which frequently develop in underwriting transactions, no part of such a commission should be accrued until the transaction is completely consummated.

Other accruals are as common with brokers as with other owners of securities. Interest accrues on bonds, both Government and corporate. Interest should not be accrued on defaulted bonds, those generally selling "flat".[1] In the case of dividends, however, a special and practical rule has developed that no accrual should be made[2] since

[1] See cases collected at 1947 P-H. Fed. Tax Service Par. 8021.

[2] American Light & Traction Co., 3 T.C. 1048, aff'd., 156 F. 2nd 398, Acq. CB 1946-2pl.

Congress has indicated its preference that dividends be reported on a cash basis whether or not the taxpayer reports on an accrual basis.

Security Transactions

Security brokers, in common with other security owners, are concerned with the tax accounting applicable to securities. To begin with, security dealers can inventory securities either at cost, or at cost or market whichever is lower, in the same manner as other taxpayers with an inventory to be valued. But different from other taxpayers, they are the only ones who can value their inventory entirely at market,[3] even if higher than cost, which means marking it up. This is an exception to the general rule that no one should ever anticipate a profit.

Traders and investors cannot inventory their position in securities for tax purposes. It becomes necessary to draw a line in determining who is a dealer in securities as distinguished from a trader and from an investor. A dealer, described briefly, is the equivalent of the store owner. He has something for sale to the general public. People are expected to go to his place of business and say, "Have you this security for sale?". The specialist in certain stocks on the floor of the stock exchange is recognized to be a dealer in such stocks.[4] The criterion is neither the volume nor the frequency of business. Volume may class one as a trader, but not necessarily as a dealer. And securities purchased for a long pull and held primarily for investment may not fall either in the dealer or trader relationship, but rather in the class of investments.

Recently the Treasury Department ruled that a dealer should, for the purpose of clarifying his position, enter securities purchased as a dealer in separate accounts from those bought for investment.[5] It is frequently very difficult to have brokers keep their accounts in that manner. It would obviously be helpful if, when the securities are bought, it were known and so recorded that the purchases were made for sale to customers in the regular course of business. Likewise if the securities were to be traded in, they should be so entered in a trading account. And finally, securities bought for investment should be separately recorded. There appears to be some doubt, however, whether the bookkeeping method of recording the transactions in securities should affect the underlying facts of the dealer, trader or investor status applicable to the particular securities.

These classifications have tax significance. A dealer can not apply the lower capital gain rates to his profits.[6] By the same token, he is not burdened with the limitation on deductions of capital losses. A trader in securities, even though his transactions are very numerous can benefit by the long term capital gain provisions applicable to securities owned over six months. This for the reason that under the provisions of Section 117 of the Code only securities held for sale to customers—those that result in the status of being a dealer in the regular course of the trade or business—are excluded from capital asset classification. Capital gains and losses can result from all other security sales.

Special situations may develop in the case of so called "wash sales". That is securities repurchased within thirty days before or after their sale. The general rule is that losses on wash sales are not deductible.[7] However, in the case of a corporation that is a dealer in securities, the wash sales provisions are not applicable, and the loss is deductible in connection with transactions made in the ordinary course of its busi-

[3] Reg. 111 Sec 29.22 (c)—5.
[4] Fried 57 Sup. Ct. 150.
[5] IT 3828, CB 1946—2 p.68-9.
[6] Code Sec. 117(a)(1).
[7] Code Sec. 118(a).

ness.[7] In the case of an individual or partnership trading in securities, the wash sales provisions are not applicable because of the impact of Section 23(e)1 upon Section 118(a) of the Internal Revenue Code. Accordingly, members of a stock exchange firm "trading" in securities are not burdened with the wash sale provisions. On the other hand, deductible losses of a corporate taxpayer doing the identical business are limited by the wash sales provisions and the losses from wash sales are not permitted.[7]

Special situations also occur in the case of short sales, arbitrages, puts and calls, commodity transactions and when-issued transactions. Owners of securities held less than six months can sell short an equivalent number of shares against the box or in a different account. Delivery of the original securities after they have been owned more than six months results in the gain being long term. And if the short sale is separately covered by an independent purchase at a loss with a corresponding increase in the overall long term gain, a development is present in which one dollar of loss absorb two dollars of gain as follows:

January 15, 1947—Purchased 100 shares of XYZ common for	$5,000	
June 15, 1947—Sold short 100 shares of XYZ common for		$8,000
July 31, 1947—Sold 100 shares of XYZ common for	9,000	
Long term gain	$4,000	
50% taken into account	$2,000	
July 31, 1947—Covered short position through purchase of 100 shares of XYZ common for		9,000
Short term loss — 100% taken into account		$1,000

By consummating their transactions as above, instead of taking $3,000 into account as a short term gain, only $1,000 is taxed at a maximum of 50%. When-issued and commodity transactions may also be timed and concluded with a weather eye on the tax results.

Corporations do not have the same problems as individuals with long and short term capital gains because the corporation does not scale down the amount of its capital gain or loss. It merely gets the benefits by a 25% limitation upon the tax imposed on the net long term gain.[8]

Year end sales of securities in which the sale on the stock exchange is made in one year but delivery made the following year are considered closed in the earlier year in the case of accrual basis taxpayers and gain or loss is then recognized.[9] If the taxpayer reports on the cash basis, a loss on such a sale is deductible in the earlier year,[10] but a gain is not realized until delivery of the securities is made in the later year.[9]

Attention should be called to a recent ruling in connection with puts and calls which permits the proceeds of the sale of exercised puts and calls to be applied against the base of the securities involved. The proceeds of the sale of puts and calls which are not exercised are treated as short-term capital gains in the year in which the failure to exercise the option becomes final.[11]

Federal stamp taxes paid upon the sale of securities must be applied to reduce the proceeds of sales.[12] State stamps paid are fully deductible as taxes.[13] Commissions, except in the case of a dealer, must be applied to reduce the proceeds of sale. In the case of transactions by a dealer in securities which are his stock in trade, it is immaterial whether you reduce the proceeds of sale by the commissions or

[8] Code Sec. 117(c)(1).
[9] IT 3485 CB 1941-1 p. 240.
[10] GCM 21503 CB 1939-2 p. 205.
[11] IT 3835, IRB 1947-2, p.4 and letter ruling December 19, 1946.
[12] IT 3806 CB 1946-2 p.41.
[13] GCM 18245 CB 1937-1 p.70.

treat them as an ordinary and necessary business expense since such security transactions result in ordinary income or loss unaffected by the capital gain provisions.

Exchange Memberships

Exchange memberships are capital assets. In recent years the dues paid to the stock exchanges have been regarded as business expenses, since the exchanges have regarded the receipts as income. There were some years when some stock exchanges did not report the dues as income, but rather as capital contributions. The members were therefore required to add the dues to the cost of their memberships, to be recovered whenever they were sold. In the case of exchange memberships which have declined in value below cost, it is not good practice to sell the membership preceded or followed by a repurchase regardless of the fact that repurchase occurs with a lapse of more than thirty days, if the transaction is prompted primarily by tax considerations. The Tax Court has raised doubts as to such a sale being a bona fide one in the regular course of business and denied deduction of the loss.[14] Because of the view adopted by the Tax Court, it did not consider it necessary to decide whether an Exchange membership was equivalent to a security, in which event, losses on wash sales would not be allowed.

Accrued Expenses

On the other side of the balance sheet we meet accrued expenses. By and large these are comparable to those of other business concerns. In the case of underwriters, there are generally met current underwriting accruals such as attorneys' and other professional fees, printing and other accruals. Brokers who employ other brokers should accrue the brokerage commissions payable.

Customers' men frequently are compensated on some practical basis which leaves part of their compensation payable after the close of the month, making accruals necessary. In the case of all accruals, it is important that a consistent practice be observed.

An item that is rather unique with brokerage firms is reflected in unclaimed items: dividends, interest, rights, scrip, etc. Some firms carry these indefinitely in a Reserve for Unclaimed Items. Others follow the practice, every year, of transfering from the reserve an amount equivalent to what remains from credits into the reserve account six or ten years earlier.

Capital Accounts

Brokerage concerns frequently credit interest during the year to partners' capital accounts. Salaries are provided for partners—in some cases in guaranteed amounts. The balance of the profit is credited or loss charged to the partners at the close of the fiscal year. The Treasury Department is not concerned with whether you label profits as interest, salaries, or other income. It is concerned with the matter of apportioning capital gains, exempt interest, contributions to charity and foreign tax credits. Such items normally would be allocated in the same proportion as the aggregate of the distribution of the income, whether it is called interest or dividends, guaranteed salaries or distribution of profits, and regardless of whether the distribution is made to a general or special partner.

Fiscal year problems come up rather frequently in Stock Exchange firms in view of the common practice of firms taking in new partners and changes occurring upon the retirement of partners or the death of a partner. We have to draw sharp lines, sometimes, as to when a new partnership relationship occurs and when we have a continuation of an existing partnership. Normally death of a partner will terminate the partnership, particularly if a new partnership

[14] Horne, 5 T.C. 250.

agreement is necessary as a result of new money being brought in by new partners. Essentially each case must be considered independently. And ordinarily it is advisable to go into the situation with the firm's counsel.

In the case of brokerage firms, we find that the readjustment of partnership interests can be the occasion of availing a particular partner of the capital gain provisions. Recently the Tax Court held upon the sale of a fractional interest to new partners, that the resulting profit was a long term capital gain.[15]

Partnership adjustments can result in distribution or evaluation of securities, and in change of partners' interests in securities and exchange memberships owned by the firm. The facts in each situation should be analyzed. Sometimes only one partner may be affected by a closed transaction involving profit or loss. And the readjustment can be planned so that the profit will be a long term capital gain.

In isolated situations it may also be desirable for a partnership owning securities that have substantially appreciated in value, to distribute them to the partners who could sell them individually. This has the effect of increasing the base of the securities so distributed to the partners with a corresponding reduction in the resulting profit. An offset develops in the reduction to the partners of the base of their partnership investment. This generally has only future rather than present significance.

In concluding this paper, attention should be called to the fact that, at the moment, Stock Exchange firms are generally partnerships. Many of them are sole proprietorships. There has recently been considerable agitation for permissive incorporation. These discussions have been prompted by the customary business considerations which necessarily include the tax phases which affect all business concerns. To the extent that taxes are an element in the attraction of capital to a security broker's business, we must necessarily weigh them as we would any other important factor in the conduct of a business. Future developments may very well bring about permissive incorporation which would serve to emphasize the corporate setup in connection with tax accounting for security brokers.

[15] Lehman, 7 T. C. #128.

Low Cost of Charity

By J. H. Landman

Business corporations, unlike other types of organizations, may not in the absence of specific legislation make contributions or gifts to philanthropy, no matter how worthy the cause. The fact that the Internal Revenue Code encourages corporate almsgiving by allowing tax deductions up to 5% of income does not excuse the wrong. On the contrary, where state law does not sanction such corporate conduct, Congress aids and abets in its commission.

Business corporations are organized to earn profits for their stockholders. The law says charity begins at home. Accordingly, from this point of view, corporate donations are misappropriated dividends. It thus behooves business corporations to examine their philanthropic policies because stockholders and creditors may challenge the propriety of their practices in this regard, particularly in less profitable years. The end of the war has eliminated many of the war-time philanthropic agencies, but it has ushered in many more postwar ones that are just as entitled to corporate as well as individual support. Many corporations in the past have been giving alms either through ignorance of or with a salutary disregard of prohibitive legislation. They should, within limitations, have their charitable conduct legalized where it is still necessary, so that they can share with individuals their recognized social responsibility to the community.

J. H. Landman, lawyer, accountant and economist, is associated with the New York office of Peat, Marwick, Mitchell & Co., where he specializes in taxation. He is a member of the Excess Profits Tax Committee of the American Bar Association and tax lecturer for its Practising Law Institute. He is also Vice-Chairman of the Tax Section of the National Association of Cost Accountants (New York Chapter). Dr. Landman is the author of the monthly column, "Tax Briefs," for the magazine "Taxes," and has written extensively on various tax subjects.

The Right of Corporations to Make Donations

Not all the states allow business corporations to grant donations to charity. Where it is permitted, corporations may avail themselves of this privilege by making such a declaration in their charters. The majority of the court decisions hold that the business corporation, unlike the religious or charitable one, has no power in the absence of statutory and/or charter authorization to make a charitable donation. The courts, however, distinguish between purely gratuitous gifts and those made in expectation of receiving profits. The former are usually considered illegal and in violation of the rights of stockholders, if legislative sanction is not provided.(1) The latter in essence are not really gifts but business expenses. The courts are very apt to exonerate the culpable corporation, if the donations are intended to further legitimate business but not political purposes. In the absence of stockholder objections, the courts permit corporate donations to humanitarian and welfare organizations, and to civic, social, educational, and recreational causes, provided corporate gain is at stake.(2) The courts are particularly ready to allow corpo-

(1) *Beers* v. *New York Life Ins. Co.*, 66 Hun 75, 20 N. Y. Supp. 788; *Wolter* v. *Johnston*, 34F (2d) 598; *McCory* v. *Chambers*, 48 Ill. App. 445.

(2) *Derr* v. *Fischer*, 22 Okla. 126, 98 Pac. 978; *Chowchilla Nat. Bank*, 200 Cal. 760, 255 Pac. 188; *McConnell* v. *Combination Mining & Melling Co.*, 30 Mont. 239; *Sherman Center Town Co.* v. *Russell*, 46 Kan. 382; *Holt* v. *Winfield Bank*, 25 Fed. 812; *Heinz* v. *Nat. Bank of Commerce*, 237 Fed. 942; *American Rolling Mill Co.* v. *Com'r*, 41 F(2) 314; *Whetstone* v. *Ottawa Univ.*, 13 Kan. 320.

rate donations to employee welfare, annuity and profit-sharing plans including those under Section 165 of the Code because they enhance amicable management-labor relations.[3] Where the corporation has no authority to make pure gifts, its directors have no such power. Under such circumstances, neither the president, manager, nor a majority of the stockholders of a corporation has the right to do so.[4] Even where statutory and charter authority is present, it would be well-advised to have by-laws prescribing designated officials to donate limited sums of corporate profits to charitable causes. Some states that permit business corporations to make contributions to philanthropic and civic enterprises to a limited extent are Connecticut, Illinois, Massachusetts, New Jersey, New York, Pennsylvania and Rhode Island.

True corporate donations to colleges and universities are more easily defended when they are restricted and are earmarked as scholarships, fellowships and funds for activities related to the corporate-donor's business activities. Similar donations to local charitable and philanthropic organizations for the advancement of community welfare, are subject to less criticism than those to comparable national or international organizations, even where the operations of the donor are national or international in scope. Of course reasonable corporate donations to employee welfare, pension and profit-sharing funds have always been least subject to challenge.

In conclusion, therefore, where enabling statutory provisions are absent, the donating of corporate funds for charitable enterprises is only defensible on business grounds. Such states recognize only the mercenary and pecuniary function of the business corporation and deny it moral attributes. Once almsgiving is tainted with the profit motive, it ceases having moral value. Accordingly, such a business corporation cannot be blamed for declaring all such disbursements in reasonable amounts as ordinary and necessary business expenditures. The Treasury may then only raise the question as to whether these items are not in reality charitable contributions. When a corporate contribution passes as a business expense it is not restricted by the facts that it must be paid in the year of the deduction, and that it is limited to 5% of net income. These contributions of gifts, deductible under Section 23(a) of the Code, must have a business purpose, and must be proportionate to the profits expected, if not realized. However, if the expenditures are philanthrophic in nature, they must be deducted as contributions rather than as business expenses. According to illustrations in the Treasury regulations, payments to a local hospital in exchange for medical services for employees, and contributions made to a convention of a remote industry, if reasonable profits are anticipated, are considered legitimate corporate deductible expenses rather than contributions. No deduction by a corporation is allowed as a business expense if any part of it is deductible as a contribution. For taxable years beginning prior to January 1, 1936, corporate contributions

(3) *Anderson*, 8 T.C., No. 78; *Steinway* v. *Steinway & Sons*, 17 Misc. 43, 40 N. Y. Supp. 718; *People ex rel. Metropolitan Life Ins.* v. *Hotchkiss*, 136 App. Div. 150, 120 N. Y. Supp. 649; *Heinz* v. *Nat. Bank of Commerce*, 237 Fed. 942.

(4) *Henry R. Worthington* v. *Worthington*, 100 App. Div. 332, 91 N. Y. Supp. 443; *Town of West Point* v. *Bland*, 106 Va. 792; *West End* v. *Eaves*, 152 Ala. 334; *Southern Hide Co.* v. *Best*, 174 La. 748; *Heller* v. *Boylan*, 29 N. Y. S. (2d) 653; *Tillis* v. *Brown*, 154 Ala. 403; *Deutsche P. Kirche* v. *Trustees of Elizabeth Presbytery*, 89 N. J. Eq. 242; *Carroll-Cross Coal Co.* v. *Abrams Creek Coal & Coke Co.*, 83 W. Va. 205; *Cassville Roller Milling Co.* v. *Aetna Ins. Co.*, 165 Mo. App. 146; *Briers* v. *Alderson*, 101 W. Va. 662; *Brayton* v. *Welch*, 39 F. Supp. 537; *Amer. Guaranty Co.* v. *Sunset Realty & Planting Co., Inc.*, 208 La. 772; *Holst* v. *N. Y. Stock Exchange*, 252 App. Div. 233; *Fitch* v. *Helvering*, 70 F(2d) 583; *Frankfort Bank* v. *Johnson*, 24 Me. 490; *Bedford R. Co.* v. *Bowser*, 48 Pa. St. 29.

were deductible only if they could qualify as business expenses. In any event, it would be well-advised for corporations to consult their counsel as to the propriety of making sizable charitable contributions.

Despite these legal handicaps, corporations almost universally support charitable and welfare organizations. Only one out of 578 manufacturing corporations which cooperated in a survey conducted by the National Industrial Conference Board in 1945 did not engage in some charitable enterprise. At least in this respect, the charge that corporations are soulless is unwarranted.

The extent to which corporations as well as individuals have availed themselves of the tax inducements offered by our tax laws to engage in philanthropic work is revealed in the following table:

CONTRIBUTIONS REPORTED ON FEDERAL INCOME TAX RETURNS

Source: United States Treasury Department's Statistics of Income (in millions of dollars)

Tax Year	Individual Contributions	Corporation Contributions
1936	390	30
1937	445	33
1938	414	27
1939	499	31
1940	740	38
1941	1,002	58
1942	1,450	98
1943	n.a.	157

Particularly in the case of corporations, these statistics underestimate the amounts of their contributions where sums have been reported as business expenses to avoid the imputation of illegal practices.

Contributions That Are Deductible

Corporate charitable contributions are at present deductible taxwise, when made to:

1. domestic corporations for domestic or foreign philanthropy;

2. trusts, chests, funds, or foundations, operated only for religious, charitable, scientific, veteran service, veteran organizations, child care, literary, or educational purposes, exclusively for domestic use, provided personal profits, political legislation, and propaganda are not encouraged thereby; or

3. the United States or any of its political subdivisions.

Contributions to individuals are under no circumstances deductible.

Though corporations may deduct up to 5% of their net incomes for normal and surtax purposes under Section 23(q) of the Code, those in an aggravated tax predicament may deduct as much as 15% of their net incomes for personal holding company surtaxes under Section 505(a)(2) of the Code, and up to 100% of their net incomes for Section 102 surtaxes. Closely held corporations are beset with this quandary. Are contributions made by them in reality dividends of their stockholders? If the donations were originally pledged in the name of the corporation and not in those of the stockholders, and the stockholders intended to derive no personal gratification from the philanthropy, the alms should not be considered constructive dividends of the stockkholders.

Contributions made by individuals in contrast with those made by corporations have tax advantages provided for in Section 23(o) of the Code. The former are limited to 15% of the taxpayer's adjusted gross income, whereas the latter are restricted to 5% of taxable income. In the case of a joint return of husband and wife, the 15% limitation applies to their aggregate adjusted gross incomes. It must be remembered, however, that the election of the standard deduction eliminates the deduction for charitable contributions because it is in part a substitution for the latter. The usual 50% limitation on long term capital gains applies in arriving at adjusted gross income.(5)

A tax-conscious donor is nonethe-

(5) *Commissioner* v. *Central Hanover Bank et al.*, CCA-2, July 24, 1947, reversing 7 T.C. 573.

less a benefactor. Too few contributors, individuals as well as corporations, avail themselves of the added tax savings attending the donating of appreciated properties instead of cash to their favorite charities. Contributions such as shares, bonds, and land which have risen in selling price since their acquisition, are worth as benefactions their fair market values on the dates of the gifts. The transfer of such gifts does not yield taxable gain to the donor. Had the donor, however, first reduced such gifts to cash before making the contributions, he would have subjected himself to a capital gains tax. On the other hand, if a property had declined in value while in the donor's possession, he would be well-advised to sell it first to take the loss to offset his taxable income before making a contribution.

Charitable contributions made by partnerships are not deductible under Section 183(c) of the Code in computing net income. Instead, each partner's share of the partnership's contributions is deductible on his individual return. However, contributions by a partnership to further its economic interests are deductible as business expenses.

Gifts Distinguished from Contributions

Taxwise, gifts must not be confused with contributions. The former are subject to the gift tax law, whereas the latter are governed by the income tax law. No business corporation may legally make gifts as distinguished from contributions of property, because such conduct would be considered clearly beyond its authority. The few state philanthropic laws are not broad enough to embrace such practices. Individuals do not have such a restriction imposed upon them. Should the latter donate more than the limitation for contributions of 15% of adjusted gross income, such sums are exempt from gift taxes, because all contributions and gifts for charitable causes are exempt therefrom. Consequently, only charitable donations made by individuals up to 15% of adjusted gross incomes are made at bargain tax prices because the Treasury shares in their costs. Gifts in excess of this limitation, though they are free from gift taxes, are made after full income taxes have been paid on them.

The Treasury's share in the cost of contributions is very generous. The income tax savings on contributions are up to 25% for corporations whose taxable incomes range up to $25,000, 53% for those corporations whose taxable incomes are in the next $25,000 bracket, and 38% for those whose taxable incomes are $50,000 or more. The income tax savings on contributions by individuals, by and large, are even greater, particularly for those in the higher income brackets. The Treasury's share in the cost is 19% for persons with surtax net incomes up to $2,000, and becomes progressively larger until a maximum of 85½% is reached for persons with surtax net incomes of more than $200,000.

The aforementioned tax savings refer to federal tax savings only. Where corporations and individuals are subject to state and local income taxes, they enjoy even greater savings on their charitable contributions.

Charity Abroad

Corporations should be apprised of the fact that for taxable years beginning after December 31, 1948, the Government will no longer share in the cost of contributions they may make to their favorite unincorporated charities, if the latter conduct their benefactions abroad. They will not be forbidden to repeat making contributions to unincorporated charities for foreign use, but they will not be permitted to deduct these sums within limits on their tax returns. They will be allowed however to make contributions to approved incorporated and unincorporated charities for domestic philanthropy as in the past, and oblige the Treasury to participate in the cost.

Apparently, Congress believes that charity by corporations in the future ought not to go to unincorporated organizations for use abroad. Strangely enough, individual taxpayers will be allowed to ignore this distinction between incorporated and unincorporated organizations for foreign charities, and will be permitted to continue their former program for charities without disturbance.

This discrimination against unincorporated institutions for foreign charities in the instance only of corporate donors was originally wrought by President Truman's December 31, 1946, proclamation declaring the cessation of World War II hostilities. It had the effect of invoking this restrictive provision in Section 23(q) of the Code for taxable years beginning in 1947 and thereafter. At no time in the history of modern man have our foreign brethren needed financial assistance more urgently than they do today to sustain them spiritually and economically. Yet corporations, in contradistinction to individuals, were discouraged by this tax law from alms-giving abroad at least through unincorporated organizations. As a consequence, President Truman signed Public Law 384 on August 8, 1947, postponing the effectiveness of this discrimination to taxable periods beginning two years hence. Of course, the full tax deduction allocable to a contribution, for an international, charitable unincorporated organization could still be enjoyed by a corporation by earmarking it for use in the United States or its possessions, but this would defeat in a large measure the purpose of the benefactor's generosity, and the gratification of the foreign recipient's need for the contribution. Since it can be argued with much cogency that all charitable organizations should submit to the jurisdiction of our corporate laws, most unincorporated charities operating abroad may be expected to become incorporated so as to attract corporate donations. In the meantime, corporate taxpayers should be aware of the tax restrictions on their future donations to unincorporated institutions for foreign philanthropy.

To commence with, it was the 1942 Revenue Act that allowed as a war measure corporate charitable deductions to all types of organizations which bestowed their bounty abroad. This blessing for the foreign war-stricken was in part short-lived because this same provision provided that contributions not to a corporation but to a trust, chest, fund, or foundation made within a taxable year beginning after the date of the cessation of hostilities shall be deductible only if they are used within the United States or its possessions. As already indicated, this special measure, included in Section 23(q) of the Code, was prematurely invoked by President Truman's proclamation of December 31, 1946, declaring hostilities at an end, but Public Law 384 deferred its effectiveness to taxable years beginning in 1949 and thereafter.

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Stock Transfer Tax

A sale of stock in New York is subject to a transfer tax of $.01 to $.04 per share, depending on the sales price. The tax applies if an agreement to sell or delivery or transfer is made in New York. However, under date of June 27, 1947, Deputy Commissioner Kassell issued a ruling that where stock is purchased outside the state by a broker acting for a customer, the transfer of the stock on the books of the corporation in New York to the name of the broker's customer is not subject to the stock transfer tax. This ruling is based upon an opinion of the Attorney General dated February 19, 1947. Commissioner Kassell's ruling adds that delivery of the certificate by mail from a point outside the state is deemed to be a delivery at that point. Apparently the only New York aspect of the transaction is the transfer of the certificate on the books of the corporation in New York and that is not a taxable event.

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University. Mr. Harrow taught accounting at The College of the City of New York from 1919 to 1924. He has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is presently serving on the Society's Committees on Federal Taxation, State Taxation, and Cooperation with the State Education Department and Its Agencies. Mr. Harrow is engaged in general practice as a certified public accountant in his own office in New York City.

City Sales Tax — Matter of Fifth Avenue Bldg. *v.* Joseph, App. Div., 1st Dept. (6/30/47)

The city assessed sales taxes for a period of eight years on purchases of coal by the petitioner. On some of these purchases the seller had presumably paid the sales tax without collecting it from the purchaser.. The court holds the purchaser liable for the tax. The sales tax is imposed upon the purchaser who normally pays it to the seller. Where the purchaser fails to pay and the seller fails to collect the tax is payable by the purchaser directly to the Treasurer. Furthermore it is the purchaser's duty to file a return and pay the tax. The law prohibits sellers from absorbing the tax.

If the seller has paid the tax and the Comptroller again collects the tax on the same transaction from the purchaser the seller may have rights of recoupment against the city but the purchaser may not offset this right against his own liability for the tax.

Franchise Tax — Matter of McAllister Bros., Inc. *v.* Bates. App. Div., Third Dept. (7/1/47)

This is an interesting case involving the proper classification of a corporation as a business corporation taxable under Article 9A or a transportation company taxable under Article 9, sections 183 and 184. The corporation was organized in March, 1936, having previously done a marine transportation business as a partnership. Under date of November 13, 1937, the corporation chartered all of its vessels and equipment to an affiliated corporation organized by it. This was done to avoid legal actions for injuries. Under the contract the parent company would receive the net profits of the affiliated company as its compensation. The corporation filed its first franchise tax

report as a business corporation under Article 9A for the privilege year commencing November 1, 1937. This return was filed under old Article 9A and was based upon activities of the corporation for its fiscal year commencing November 1, 1936, and ending October 31, 1937. The tax Commission in March, 1939, notified the corporation that since it was engaged in the business of towing and lighterage, it was a transportation company and hence reclassified it as a corporation taxable under Article 9A.

The privilege year for transportation companies is the calendar year. Consequently the corporation filed its franchise tax returns for the calendar years 1942 and 1943 as a transportation company. These were based upon business operations for the corporation's fiscal years ending October 31, 1941, and October 31, 1942, respectively. The operating income for these years was substantial.

The Corporation Tax Bureau at this time conducted an investigation of the activties of both corporations and determined that the corporation had been classified erroneously as a transportation company and that it should be taxed under Article 9A as a business corporation.

The court held that the corporation was properly taxed as a business corporation. It held only the title to its vessels having parted with all supervision and control of its property for the charter period, and received the net profits from another corporation as rental. This case was distinguished from *People ex rel. N. Y. & Albany Lighterage Co.* v. *Cantor*, 239 N. Y. 64, where the corporation chartered individual vessels for particular hauling jobs as an incident of its own active transport operations.

The case was distinguished also from *People ex rel. Peter J. Curran Funeral Service Co., Inc.* v. *Graves*, 257 App. Div. 888. In this case the corporation retained complete control over the use and operation of hearses and automobiles that it furnished for funerals, keeping the cars in operating condition and directing the services of each chauffeur.

The court ruled that the nature of the business carried on determines its classification for franchise tax purposes, rather than the purposes for which the corporation is organized. It ruled, also, that the State Tax Commission may change the classification of a corporation for franchise tax purposes as the corporation shifts from one kind of business to another.

A transportation company pays an annual tax measured by capital stock (section 183) and an additional franchise tax measured by gross earnings (section 184). In this case obviously a tax on net income under Article 9A resulted in a greater tax.

It might be noted that the two corporations involved in this case would not be permitted to file a combined return, since there is no provision in the law permitting a consolidation of a business company and a transportation company. The result works a special hardship to the corporations, since the intrastate gross income of one company is subject to a tax of 5/10 of 1% and when the net income is turned over to the parent company that portion of the gross income is again subject to tax. If the tax aspect of the arrangement between both companies is most important, the way is open for the corporations to bring themselves within the provisions of the two cases distinguished in the opinion.

Gross Receipts—Matter of Guardian Life Insurance Co. of America *v.* Joseph. App. Div., 1st Dept. (6/30/47)

The Comptroller assessed additional gross receipts taxes on annuity receipts which the taxpayer had excluded in determining receipts from the business of insurance.

The decision hinged on the definition of premiums. Receipts from the business of insurance are defined to mean

receipt from premiums received in and from risks in New York City. The company argued that receipts from agreements for the payment of annuities are not premiums.

The court in its decision referred to the case of *People ex rel Metropolitan Life Insurance Co.* v. *Knapp,* 193 App. Div. 413, aff'd., 231 N. Y. 630, which came before it under Section 187 of the Tax Law. That case held that money received from the sale of annuities did not fall into the category of premiums. Section 187 was amended in 1937 by subdivision 2 which provided that "the term 'premiums' * * * shall include all amounts received as consideration for insurance contracts, *other than a consideration received for annuity contracts*".

The court next ruled that in the adoption of a similar type of tax for New York City the same construction was intended to be placed upon the term "premiums" and that it is a familiar canon of construction that where one legislative body—the Legislature of the State—enacts an enabling statute permitting the legislative body of a city to pass a tax law, the latter legislative body acting for the city, which is but a creature of the State, must be held to have used definitive terms in its local laws with the meaning and definition given and ascribed to those terms by the State Legislature when it created, defined and used them.

The Comptroller next sought to tax the receipts from annuity contracts as receipts from other types of business transactions, in that such receipts were not from the business of insurance. Again the court said no. Section 46 of the Insurance Law enumerates the kinds of insurance authorized and the making of agreements to pay annuities is enumerated as one of them. As a matter of fact it is a variety of the business that can be conducted only by an insurance company under the supervision of the superintendent of insurance. So under the gross receipts tax receipts from annuities are exempt from tax since they are not premiums although they are part of the insurance business. Not always is taxation a practical matter. Sometimes logic and precedent receive the approval of courts.

Estate Tax — Estate of R. H. Goffe, Surrogate's Court, N. Y. County, N. Y. Law Journal, June 3, 1947.

A provision in a will provided that estate taxes should be paid from the residuary estate. The net taxable estate included the proceeds of life insurance policies payable to named beneficiaries and a joint estate which passed to the surviving joint tenant. The issue before the Surrogate was whether the residuary estate should be charged with that portion of the estate tax covering the life insurance proceeds and the joint estate. The Surrogate held that the provision in the will related only to the assets passing under the will and therefore the beneficiaries of the insurance proceeds and the surviving joint tenant were obligated to pay their ratable proportion of the estate taxes.

To the same effect was the decision in *Estate of W. Alexander,* Surrogate's Court, N. Y. County, N. Y. Law Journal, June 10, 1947.

Here a daughter was the beneficiary of an insurance policy. She was also a co-executor and an income beneficiary of a trust consisting of substantially all the assets of the estate. The court held that section 124 requires an equitable proration of estate taxes except where the will contains a plain and unmistakable direction to the contrary. Here the court found that the direction in the will was inapplicable to non-testamentary gifts and these, therefore, should bear their proportionate share of the taxes.

However, in *Estate of W. A. Winterbottom,* Surrogate's Court, Queens County, N. Y. Law Journal, June 5, 1947, the testator directed that "any and all taxes, both state and federal, which may be imposed by any law * * * upon my estate * * *" be "paid out of

my estate". This was construed by the Surrogate to include property passing outside the will as well as under the will. Consequently, beneficiaries of life insurance policies were not required to pay a ratable portion of the estate taxes and the resulting tax was chargeable upon the residuary estate.

Apparently attorneys who draw wills should carefully ascertain their client's intention in drawing up the provision for the payment of estate taxes.

Estate Tax — Estate of R. Pulitzer, Surrogate's Court, N. Y. County, N. Y. Law Journal, June 18, 1947.

Like the previous case, a decedent's widow was required to contribute a proportionate part of estate taxes attributable to proceeds of insurance on the decedent's life that did not pass under the will. However, in this case the decedent's estate was insolvent and the widow had advanced money to the executors to pay gift and income taxes claimed by the Federal government on account of an *inter vivos* trust created by a decedent in her favor. There was no agreement said the court, express or implied, requiring the estate to reimburse the widow for sums advanced to pay the income and gift tax claim.

Estate Tax—Estate of M. L. Shaine, Surrogate's Court, N. Y. County, N. Y. Law Journal, June 26, 1947.

And in this case no apportionment of estate taxes was made since the will directed that assets not specifically bequeathed be converted into cash and further that all taxes be paid out of the cash.

Estate Tax — Estate of B. Bernie, Surrogate's Court, N. Y. County, N. Y. Law Journal, June 5, 1947.

The New York Decedent Estate Law provides for an apportionment of estate taxes unless the will provides otherwise. This case involved the estate of a non-resident and the Surrogate ruled that Sec. 124 of the Decedent Estate Law does not apply to a non-resident estate; that the apportionment of such taxes is governed by the law of the domicile of the decedent. The decedent was domiciled in Florida and there was no provision in the will respecting the burden of estate taxes. There was no statute in Florida corresponding to Section 124 of the New York Decedent Estate Law.

Sales Tax — N. Y. World Telegram Corp. *v.* McGoldrich, N. Y. Supreme Court, App. Div., 272 App. Div. 806.

Prior to the effective date of the sales tax law, property consisting of a building and machinery was delivered to the taxpayer under a lease providing for payment of rent, depreciation and certain expenses. The taxpayer had an option to buy the property for cost less the amounts paid by the taxpayer for depreciation. The taxpayer contended that the arrangement was in substance an installment sale not subject to sales tax. The court ruled that the amounts paid under the lease for use of the machinery represented rentals of tangible personal property and were subject to sales tax.

Accrual of Franchise Tax Under Internal Revenue Code

A recent Tax Court Case highlights an important difference between the accountant's concept of accrual and the legal point of view. In *Durst Productions Corp.* v. *Comm.*, 8 TC (No. 58), the court held that the accrual date of the franchise tax under new Article 9A which became effective March 31, 1944, was on the last day of the corporation's fiscal year. The corporation reported on a fiscal year basis ending May 31, 1944. The return which was due in September 1944, though based upon the fiscal year ending May 31, 1944, covered the privilege year from November 1, 1944, to May 31, 1945. There was no legal accrual of the tax until November 1, 1944, but the court said that a tax could be accrued even if it was not yet due. It added "the tax

being calculated on the amount of earnings for the year in issue its charge against those earnings seems to accord with the theory of accrual." This statement of course is in accord with the accountant's concept of accrual, but we are familiar with the numerous decisions that have ignored this concept and instead set up the legal accrual of a tax as the proper date. This decision refers to *U. S.* v. *Anderson*, 269 U. S. 422, one of the early important decisions that gave recognition to accounting principles.

The case has other interesting aspects. In 1944, the Bureau issued a ruling (I.T. 3697, 1944 C.B. 116) holding that the franchise tax accrued on the first day of the corporation's fiscal or calendar year, since the tax is for the privilege exercised for any part of the year. This ruling will now have to be revoked by the Bureau, if it accepts the *Durst* decision.

Under the new Article 9A, the privilege year and the base year are now the same. To accomplish this change over from old 9A, the law provided a transition period before the new law became fully operative. The 1944 and 1945 returns therefore both covered the privilege year November 1, 1944, to May 31, 1945, for the *Durst* corporation. If the franchise tax for both years accrued legally on November 1, 1944, the corporation was entitled to a double deduction. That is, the 1944 franchise tax return based upon net income for the fiscal year ending May 31, 1944, and the 1945 franchise tax return based upon net income for the fiscal year ending May 31, 1945, could be accrued and taken as deductions on the federal income tax return filed by the corporation for the fiscal year ending May 31, 1945. The Bureau in fact had approved this double deduction. But the *Durst* case is silent on the double deduction and that decision itself is definitely not in accord with this concept of a legal accrual. The *Durst* case, while sound from an accounting standpoint, has helped to muddle the question of when to take a deduction for franchise taxes and further litigation may be expected on this issue.

The Court also referred to the Commissioner's treatment of a comparable Tennessee corporate tax (G.C.M. 25202, IRB 1947-8-122525). This ruling held that for federal income tax purposes the Tennessee corporate excise tax and the corporate franchise tax accrued at the close of the taxable year next preceding the date on which they are payable. This ruling incidentally reflected a revision of an I.T. issued in 1938.

Our own opinion on this situation is that the tax accrues on the first day of the privilege and base year, rather than the last day. There is an immediate liability for the franchise tax when the corporation commences exercising its corporate franchise. Only the amount of tax is uncertain at that moment. This of course is determinable on the last day of the base year. From the point of view of deductibility for federal income tax purposes it does not make any difference whether the tax accrues on the first day or the last day. For 1944 and 1945, when the base year and privilege year were not the same, the accrual date makes a difference. The decision in the *Durst* case would seem to be wrong, unless the Court took into account a provision in the 1944 franchise tax law, repealed the following year, for a dissolution tax. Under old Article 9A a corporation could avoid a prospective franchise tax based upon a profitable base year by dissolving any time before November 1st, the first day of the new privilege year.

The dissolution tax sought to prevent this avoidance of tax by providing that a corporation should be liable for a tax on all income not previously made the basis of a tax up to the date of dissolution. Since new Article 9A became law on March 31, 1944, presumably it applied to all corporations dissolving after March 31, 1944, and before November 1, 1944. While the *Durst*

opinion is not clear on this aspect of the case it may be that the court had in mind the fact that this dissolution tax accrued on March 31, 1944.

The Tax Court recently rendered an opinion on the accrual of the California Franchise tax (*Central Investment Corp.*, 9 T.C. #17) which seems to be directly opposed to the *Durst* decision. This editor will comment further on the entire situation in the next issue of the State Tax Clinic.

Tax Benefit Principle Under Franchise Tax on Banks

The regulations under Articles 9B and 9C provide that a recovery of a bad debt previously deducted shall not be included as income to the extent that the prior deduction did not result in a tax benefit.

A situation has been submitted to us where there has been a deduction for bad debts in a prior year and a recovery in a later year. However, in the prior year the franchise tax was computed on capital and not on income. Query: Is the recovery to be reported as income in the later year? The applicable regulation, Article 52-a, reads in part as follows:

> "Recoveries on loans (exclusive of those evidenced by bonds or other securities) charged off at the direction of federal or state bank examiners acting under authority from the Comptroller of the Currency or the State Superintendent of Banks may be excluded from gross income to the extent that such writeoffs did not serve to reduce the amount of tax computable upon net income in the year made.
>
> "Where such debts (when charged off did serve to reduce the tax computable upon net income, recoveries thereon may be excluded until they equal in the aggregate the sum of the chargeoffs not accomplishing a reduction in tax liability."

In our opinion the recovery is not includible as income since there was no tax benefit under the income basis in the prior year.

Accounting At the S. E. C.

Conducted by WILLIAM W. WERNTZ

THIRTEEN years ago the Securities and Exchange Commission was created to administer the Securities Act of 1933 and the Securities Exchange Act of 1934. Since then, it has adopted extensive accounting requirements, issued many formal opinions dealing with accounting questions and authorized the release of staff opinions by its Chief Accountant discussing numerous accounting questions not specifically dealt with in formal rules. Of equal importance is the fact that the Commission and its staff have had to meet and solve innumerable cases involving accounting matters not falling squarely within any of its specific rules or opinions but lying instead in the sometimes vague area of "generally accepted accounting principles." Were the Commission's accounting decisions and requirements of significance only in respect of financial data required to be filed with it under one or another of the statutes it administers, its rules would nevertheless be of importance to a large segment of accounting practitioners. Actually, these requirements and decisions have come to have in non-S.E.C. accounting fields a status somewhat like what legal scholars call "persuasive authority"—that is, decisions which, while not controlling, cannot, for one reason or another, be ignored, and will usually be followed in the absence of strong and carefully considered countervailing circumstances.

WILLIAM W. WERNTZ, formerly Chief Accountant of the S.E.C., is now associated with Touche, Niven, Bailey & Smart, C.P.A.'s.

Mr. Werntz is a graduate of Yale University and of Yale Law School, and is a member of the Connecticut Bar. He was formerly an instructor of accounting at Yale University and Yale Law School. He was also an accounting consultant to the O.P.A. and the Treasury Department.

Mr. Werntz is the author of numerous articles which have appeared in technical accounting publications. He is Vice-President-elect of the American Accounting Association.

S.E.C. accounting has attained this status of persuasive authority in non-regulated fields for a number of reasons. To begin with, the Commission, before adopting rules, has actively sought to obtain the views of registrants and accountants who appear before it. In addition, its accounting regulations and staff opinions have almost invariably been issued only after close consultation with cooperative committees of the various professional and technical societies and associations, such as the New York State Society of Certified Public Accountants, the American Institute of Accountants, the Controllers Institute, the American Accounting Association, and the National Association of Cost Accountants. Recently the Federal Administrative Procedures Act formalized this consultative process by prescribing that most substantive changes in rules, including accounting rules, could be made effective only after public notice and suitable opportunity for comment by those interested.

In the second place, the list of companies which must file financial statements with the Commission includes most of the large national companies and a very substantial percentage of the smaller but well known regional corporations. As more and more companies seek to list their securities on a national securities exchange or to raise capital in the public markets, the list of registered companies will continue to grow. In a recent report to Congress, the Commission estimated that there remained some thousand or so industrial or commercial companies having assets of over $3,000,000 and more than 300 stockholders that were not then filing reports with the Commission. The an-

nual stockholder reports of registered companies are not ordinarily subject to S.E.C. requirements, nor are their reports prepared for general public release or for special credit purposes so subject. Nevertheless, such companies and their accountants will obviously be loathe to issue reports for any purpose that differ in any fundamental respect from those on public file at the Commission. Condensation or expansion there may be, as the needs of the particular situation vary, but it would be extremely perilous in such other reports to arrive at materially different results, certainly at least without the clearest sort of explanatory disclosure—an always distasteful procedure. In consequence, it may fairly be expected that *all* reports of registered companies will be in general conformity with S.E.C. requirements, at least for so long as those requirements continue to be based on sound and acceptable accounting concepts. It may be needless to add that the standards of financial reporting and accounting practices established by this group of registered companies and their public accountants are properly regarded as having a very material bearing on the adequacy and acceptability of the reporting and accounting practices of companies not yet within that group.

The Commission's requirements and opinions have also influenced developments in the field of auditing. The Securities Acts of 1933 and 1934 in essence require the independent accountant to make a "reasonable" examination or investigation as a basis for expressing his expert and impartial opinion. Should the reasonableness or impartiality of an accountant's report be put in issue in a suit under these statutes, it seems certain that failure to observe the Commission's requirements would weigh heavily against the accountant. In suits involving similar issues, but not founded in these two statutes, it is likely that Commission requirements and opinions would be accorded considerable weight.

It is for these reasons that the editor and the editorial board have felt accounting at the S.E.C. to be of such interest to all accountants who participate in the work of preparing financial statements for public or private use as to warrant the launching of a department devoted to accounting developments and practice at the S.E.C. While the form and content of such a department will ultimately depend on the comments, criticisms and suggestions received from readers, it seems appropriate to begin by noting and commenting upon new accounting rules or opinions, and upon proposed rules released for comment. Where possible and available, administrative solutions reached in particular cases involving novel or interesting accounting points will be presented. However, the facts and results of such cases, despite their current interest, are usually hard to come by. Since there is no regular means for publicizing them, only the registrant involved, its public accountants and members of the Commission's staff will usually be aware of the circumstances. We have the hope, however, that readers will, perhaps reluctantly, take pen in hand and call attention to appropriate cases.

Two items of interest to accountants will be used as a starter. The first deals with a recent accounting series release; the second consists of some curious quasi-accounting language relating to certain mortgage provisions.

* * *

Most accountants will doubtless agree with the views expressed in Accounting Series Release 62 issued on June 27, 1947. The release deals largely with the scope of examination necessary in order for an accountant to permit the use of his name in connection with the "summary earnings tables" generally found in prospectuses. Mr. King, the Chief Accountant, classifies such summaries as a species of income statement and concludes that "it is generally improper and misleading for an accountant to permit his name to be

used in connection with any period covered by a summary earnings table, or to undertake to express his professional opinion as to the fairness of the representations made for such period in a summary earnings table unless he has made an examination for such period in accordance with generally accepted auditing standards applicable in the circumstances. . . . If the instant work represents the first engagement of the accountant by the registrant and he is to express his expert opinion with respect to the earlier periods contained in the summary, it would, in my opinion, be necessary for the accountant to apply to the operations and transactions of each of the earlier periods with respect to which he is to express an opinion substantially the same auditing procedures as those employed with respect to the first two years of the three-year certified profit and loss or income statement included in the registration statement."

The opinion goes on to state that the accountant's report should assume a form comparable to that required by Rule 2.02 of Regulation S-X. If such is the case and the opinion or report is to be kept reasonably brief and lucid, consideration ought to be given to the question of whether it is not both appropriate and desirable (in view of the length of the period and the less detailed presentation) to forego or at least to condense many comments and explanations that would be required and desirable in reporting upon the accounts of the current year or of two or three recent years. This raised standard of "significance" would seem to be even more appropriate in deciding what footnote explanations or disclosures ought to accompany the summary. A further interesting question in this connection is whether an exception should be taken as to accounting practices which were recognized as acceptable in earlier years but which are considered to be questionable or improper when the accountant's opinion is issued. Finally, there is the question as to whether an item that is defined as "extraordinary, unusual, or non-recurring" in respect of one year's accounts is entitled to such a classification, and perhaps exclusion from the income account, when a ten-year period is covered.

Release 62 raises but does not seek to answer any of these questions directly although its last paragraph invites them. There is not, however, an indication of any intended change in pre-existing practice in such problems. It is therefore a matter for current speculation whether or not the requirement of a more formal and detailed expression of the accountant's opinion as to the earnings summary eventually may result in increasing the number of qualifications in such opinions or in more recasting the accounts than heretofore.

* * *

Mortgage conditions or covenants stated in what seem to be accounting terms and apparently related to some common accounting concepts are still apt to be almost undecipherable in application. Witness the following description in a recent SEC opinion:

> "The mortgage provides that for each year beginning with the year 1944 the company will *expend* for maintenance and repairs of the mortgaged property and automotive equipment of the company used in its electric and/or gas utility business 15% of adjusted gross operating revenues, but not in excess of *actual expenditures* for maintenance and repairs of such property during such year plus $2,000,000 plus 2½% of net property additions subsequent to December 31, 1943. The mortgage further provides that any deficiency in the replacement fund may be made up by a *deposit of cash* with the trustee or by the certification of *gross property additions*, which property additions may not thereafter be made the basis of authentication and delivery of bonds, release of property or withdrawal of cash." (Emphasis supplied).

ary,
pect
l to
ex-
hen

seek
di-
in-
, an
e in
ems.
rent
ire-
iled
ion
ally
ber
or
han

ants
ting
ome
still
ap-
de-
:

for
year
for
ort-
tive
l in
ness
ting
tual
l re-
uch
of
t to
gage
ency
nade
the
ross
erty
nade
de-
erty
asis

1